S. Hrg. 98-345

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1174

TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935 TO SIMPLIFY ITS ADMINISTRATION, TO ENSURE STATE REGULATORY ACCESS TO NECESSARY INFORMATION, TO REMOVE CERTAIN REGULATORY RESTRICTIONS ON BUSINESS PRACTICES WHERE SUCH RESTRICTIONS ARE NO LONGER NECESSARY TO THE PROTECTION OF INVESTORS AND CONSUMERS

JUNE 14 AND 15, 1983

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PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983

TUESDAY, JUNE 14, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room 538, Dirksen Senate Office Building, Senator Alfonse D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Sarbanes.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning. The Subcommittee on Securities today will begin the first of 2 days of hearings on S. 1174, a bill which would amend the Public Utility Holding Company Act of 1935.

S. 1174 is evidence that legislation is a continuing process, not a single event. Last year marked the beginning of the process to amend the Holding Company Act.

In the 97th Congress, Senator Johnston and I introduced a total of four bills which ranged in content from outright repeal of the Holding Company Act to modification of only one of its provisions. I conducted 3 days of hearings in the Securities Subcommittee on these bills (Apr. 27, June 8, 9, 1982) and in the process established that there was a lack of consensus on the issue of whether or not to reform or repeal the Holding Company Act. The discord was evident even within individual interest groups and industries.

On the final day of last year's hearings I concluded that I was opposed to the outright repeal of the Holding Company Act, and I admonished the groups not to come back to Congress until there was a more reasonable and unified approach. S. 1174 is the culmination of prodigious efforts over the past year to draft a bill which reflects the legitimate concerns of ratepayers, investors, State regulators, and utility management.

The Public Utility Holding Company Act, enacted in 1935, is administered by the SEC. It was enacted to eliminate the abusive acts practiced by the utilities in the 1920's. The Holding Company Act was intended to protect both the investor and the ratepayer by providing Federal regulation in the regulatory void where the States lacked jurisdiction. The Holding Company Act authorized the SEC to require utility holding company systems to adopt integrated, simplified structures and to prevent the recurrence of abusive practices through the regulation of utility financing, acquisition, and disposition of assets and contracts.

The current debate centers on whether or not the Holding Company Act, after 50 years of service, is a regulatory dinosaur. No one questions whether the Holding Company Act was needed in 1935 or how well it served its purpose. However, we must now examine the Holding Company Act in light of the current regulatory environment. Any consideration of the Holding Company Act will be controversial because the Holding Company Act involves the regulation of electric and gas utilities, and as we all know, public utilities are monopolies that are part of the foundation of our economic and social life.

Nevertheless, I believe that there are creaks and cobwebs in the operation of the Holding Company Act that have no place in our present regulatory environment or our modern marketplace.

S. 1174 would modernize the Holding Company Act in several important respects. For example, the exemptive provisions in the act would be expanded and amended to inject more certainty into the administration of the statute. Second, the bill would expedite the processing of securities offerings and create a system of "shelf registration." Third, the bill would relax present restrictions on diversification by public utility companies in holding company systems, while tightening up the anticonglomerate features of the act. Fourth, the bill would invigorate the successful Federal and State regulatory partnership by creating a new federally enforceable right for State commissions to gain access to books, records, and accounts concerning nonutility activities.

In my judgment, S. 1174 preserves and perpetuates the fundamental policies underlying the Holding Company Act. With these revisions, the Holding Company Act will be able to endure for another 50 years.

The beneficiaries of procedural reform and prudent diversification will be consumers, shareholders, State regulators, the SEC, and of course the holding companies and their public utility subsidiaries.

S. 1174 does not address satisfactorily every concern which was raised in the course of the hearings last year. Although diversification has clearly been permitted under the Holding Company Act for half a century, S. 1174 would expand the nonutility activities of utility holding companies. Small businesses may have difficulty competing against a utility subsidiary. As a member of the Senate's Small Business Committee, I am generally sensitive to questions of unfair competition. And as a member of the Banking Committee, I have expressed this same concern in the context of the Bank Holding Company Act regarding fair competition, equal access to capital, and tie-ins.

I support fair competition in all areas of commerce and industry and I intend to explore the allegations made by some of today's witnesses with officials off the SEC, the Justice Department, the Small Business Administration, as well as their State counterparts. I am pleased that the Small Business Committee plans additional and specific hearings on these problems. And I am hopeful that the hearing record of S. 1174 will result in additional constructive suggestions and additional dialog between all of the affected parties will ultimately produce a satisfactory compromise.

[Copy of bill being considered follows:]

98TH CONGRESS
1ST SESSION

S. 1174

To amend the Public Utility Holding Company Act of 1935 to simplify its administration, to ensure State regulatory access to necessary information, to remove certain regulatory restrictions on business practices where such restrictions are no longer necessary to the protection of investors and consumers, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 28 (legislative day, APRIL 26), 1983

Mr. D'AMATO (for himself and Mr. JOHNSTON) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Public Utility Holding Company Act of 1935 to simplify its administration, to ensure State regulatory access to necessary information, to remove certain regulatory restrictions on business practices where such restrictions are no longer necessary to the protection of investors and consumers, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Public Utility Holding Company Act Amendments of 1983".

FINDINGS AND STATEMENT OF PURPOSES

SEC. 2. (a) The Congress hereby finds that—

(1) business, market, and regulatory developments over the forty-eight-year history of the administration of the Public Utility Holding Company Act of 1935 have rendered certain of the original provisions of the Act—

(A) unnecessarily restrictive of business activity; or

(B) duplicative of a broad range of regulatory controls administered by State and Federal authorities under a number of other laws; and

(2) the lessening of regulatory burdens and controls imposed on holding-company systems and the reform of regulatory requirements can be accomplished under the Public Utility Holding Company Act of 1935 in a manner and to a degree entirely consistent with the protection of investors and consumers.

(b) The purposes of this Act are—

(1) to ensure that State regulatory authorities have access to information concerning the operation of holding-company systems necessary to the performance by such State regulatory authorities of the functions imposed upon them by law;

(2) to remove certain regulatory restrictions on business practices where such restrictions are no longer necessary to the protection of investors and consumers;

(3) to reduce regulatory uncertainties in the administration of the Public Utility Holding Company Act of 1935; and

(4) to simplify and allow for greater flexibility in the administration of the remaining requirements of the Act.

DEFINITIONS

SEC. 3. Section 2 of the Public Utility Holding Company Act of 1935 is amended in subsection (a)—

(1) by striking paragraph (18) and inserting in lieu thereof the following:

"(18) 'Utility assets' means the facilities, in place, of any electric utility company directly employed in, and the primary function of which is, the generation, transmission, or distribution of electric energy; or the facilities, in place, of any gas utility company directly employed in, and the primary function of which is, the distribution at retail of natural or manufactured gas."; and

(2) by adding at the end thereof the following paragraphs:

"(30) 'Issue' includes the sale, renewal, guaranty of or assumption of liability on any security.

"(31) 'Consumers' means the utility customers of a public-utility company which is an associate company in a holding-company system.".

EXEMPTIONS FROM THE HOLDING COMPANY ACT

SEC. 4. Section 3 of the Public Utility Holding Company Act of 1935 is amended—

(1) In subsection (a)—

(A) by inserting "unconditionally" before "exempt any holding company" in the first sentence of such subsection;

(B) by striking "any provision or" and inserting "all" before "provisions of this title" in the first sentence of such subsection;

(C) by striking from ", unless" through "consumers" in the first sentence of such subsection and inserting in lieu thereof: "except section 3A and paragraph (2) of subsection (a) of section 9, unless and except insofar as the Commission, acting on its own motion or upon the request of a State commission having jurisdiction to regulate a public-utility company in the holding-company system, shall by order determine, by specific factual findings made upon clear and convincing evidence, that the exemption materially adversely affects the public-utility business of such holding-company system";

(D) by striking in paragraph (4) "; or" and inserting in lieu thereof ";";

(E) by striking "." in paragraph (5) and inserting in lieu thereof "; or"; and

(F) by adding at the end thereof the following new paragraph:

"(6) such holding company has only one subsidiary company which is a public-utility company and the operations of such subsidiary company as such do not extend beyond the State in which it is organized and States contiguous thereto: *Provided, however,* That such public-utility company may be a holding company which qualifies for an exemption under paragraph (2).";

(2) in subsection (c)—

(A) in the last sentence of such subsection—

(i) by striking "issuance of such order" and inserting in lieu thereof "exemption"; and

(ii) by inserting after "shall": ", unless a proceeding is pending under subsection (e),";

(B) by adding a new last sentence to read as follows: "Any finding that the exemption under subsection (a) materially adversely affects the public-utility business of a holding-company system shall be made in accordance with the procedure set forth in subsection (a).''; and

(3) by inserting a new subsection (e) to read as follows:

"(e) Whenever the Commission shall have determined that an exemption under subsection (a) materially adversely affects the public-utility business of a holding-company system, the Commission shall by order revoke the exemption: *Provided, however,* That the Commission shall permit such holding company an opportunity, in accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, to submit to the Commission a plan which, as submitted or as modified, after notice and opportunity for hearing, the Commission finds adequate to cause the exemption not to materially adversely affect the public-utility business of such holding-company system and to be fair and equitable to the persons affected by such plan. If the Commission makes such finding it shall enter an order approving such plan, and the exemption shall remain in effect. The terms and provisions of a plan approved under this subsection may be enforced in the same manner as a plan approved under subsection (e) of section 11.".

STATE COMMISSION MONITORING OF AND ACCESS TO INFORMATION RESPECTING BUSINESS ACTIVITY

SEC. 5. The Public Utility Holding Company Act of 1935 is amended by adding a new section to read:

"STATE COMMISSION MONITORING OF AND ACCESS TO INFORMATION RESPECTING BUSINESS ACTIVITY

"SEC. 3A. (a) Upon the written request of a State commission having jurisdiction to regulate a public-utility company in a holding-company system, and subject to such terms and conditions as are appropriate and necessary to safeguard against unwarranted public disclosure of any confidential business information, a holding company shall produce, or cause any associate company in the holding-company system to produce, for inspection of the requesting State commission such of its books, records, and accounts with respect to its nonutility business activities as—

"(1) have been identified in reasonable detail in a pending proceeding before such State commission; and

"(2) can be shown to be necessary to the performance by the State commission of functions imposed upon it by law in connection with the pending proceeding described in paragraph (1).

"(b) The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of all actions at law or in equity brought by the State commission making a request under subsection (a), a holding company, an associate company of such holding company, or officer or director of any thereof, to construe subsection (a) or to enforce any liability, duty, or immunity created by it. No other right of action shall arise under such subsection. Any such action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or where the defendant may be found. In any proceeding to enforce subsection (a) the State commission shall have the responsibility to demonstrate to the satisfaction of the court that the production of such books, records, and accounts is necessary to the performance by such State commission of functions imposed upon it by law. Any action brought under this subsection shall to the greatest extent practicable be expedited by the court and given precedence with respect to other matters then pending on the docket so as to permit the court to render its decision relative to such action within sixty days from the date such action is brought, unless the court determines that a longer period is necessary to satisfy requirements of the United States Constitution.

"(c) The Commission, upon its own motion or upon the application of any State commission having jurisdiction to regulate any public-utility company in a holding-company system, may, by such rules or regulations as it determines to be required in the public interest, provide for the filing, with the Commission and any such State commission, of uniform reports concerning the nonutility business activities of holding-company systems. Such rules or regulations may provide for the filing of such reports on a periodic basis: *Provided,* That such reports shall not be required more often than biennially. In determining whether to exercise its authority under this subsection and in determining the nature and level of detail in any such uniform reports, the Commission shall give due consideration to the need to avoid unnecessary duplication in reporting of information otherwise contained in public filings under the securities laws or otherwise and the need to safeguard against unwarranted public disclosure of any confidential business information.

"(d) Nothing in this section shall—

"(1) subject a holding company or any associate company thereof to the jurisdiction of a State commission, except as specifically provided herein; or

"(2) be construed to invalidate, supersede, or impair the exercise of authority by the several States under laws duly enacted by any such State respecting the compulsory production or inspection of books, records, and accounts in connection with the regulation of public-utility companies doing business in such States, except that no requirement under State law with respect to the public disclosure of information obtained pursuant to the authority of this section shall apply to require the disclosure of confidential business information in a manner inconsistent with terms and conditions applicable under subsection (a) as appropriate and necessary to safeguard against the unwarranted disclosure of such information.".

TRANSACTIONS BY UNREGISTERED HOLDING COMPANIES

SEC. 6. Sections 4, 5, and 29 of the Public Utility Holding Company Act of 1935 are amended as follows:

(1) in section 4(a) by striking out "(a) After December 1, 1945, unless" and inserting "Unless";

(2) in paragraph (6) of section 4(a) by striking out ", of this subsection";

(3) by striking out subsection (b) of section 4;

(4) in section 5(a) by striking out "On or at any time after October 1, 1935, any" and inserting "Any"; and

(5) in section 29 by striking out "subsection (a) or (b) of".

REFORM OF SECURITIES-ISSUANCE CONTROLS

SEC. 7. Sections 6 and 7 of the Public Utility Holding Company Act of 1935 are amended to read as follows:

"REGULATED SECURITY TRANSACTIONS BY REGISTERED HOLDING AND SUBSIDIARY COMPANIES

"SEC. 6. (a) Except in accordance with a declaration effective under section 7, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly, to issue any security unless the issue is exempted from this subsection under subsection (b).

"(b)(1) The provisions of subsection (a) shall not apply to—

"(A) the issue of a note or draft (including the pledge of any security as collateral therefor) if such note or draft—

"(i) is not part of a public offering;

"(ii) matures or is renewed for not more than twelve months, exclusive of days of grace, after the date of such issue; and

"(iii) aggregates (together with all other then-outstanding notes and drafts of a maturity of twelve months or less, exclusive of days of grace, as to which such company is primarily or secondarily liable) not more than 10 per centum of the aggregate of the capital, capital surplus and retained earnings, and the principal amount of the other securities then outstanding of the company issuing such note or draft;

"(B) the issue of a security by a subsidiary company which is a public-utility company if such issue is expressly authorized by the State commission of the State in which such subsidiary company is organized and doing business, as such;

"(C) the issue of a security by a subsidiary company which is not a public-utility company; or

"(D) the guaranty of, or assumption of liability on, a security of a subsidiary company by its registered holding company, if the aggregate of the principal amount and par value of the securities then outstanding of all subsidiary companies which are the subject of all such guaranties and assumptions of liability by such registered holding company is not more than 10 per centum of the aggregate of the capital, capital surplus and retained earnings, and the principal amount of the other securities of such registered holding company then outstanding.

"(2) Notwithstanding the exemptions provided in paragraph (1), the Commission may, by rule, regulation, or order, establish such requirements with respect to the consolidated capital structure of a registered holding-company system as the Commission finds are necessary to prevent an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under sections 6, 7, and 12.

"(3)(A) In addition to the exemptions provided in paragraph (1), the Commission may, by order, upon application by a registered holding company or subsidiary company thereof, exempt from the provisions of subsection (a) the issue of any security if the Commission determines that the application of subsection (a) to such issue is not necessary or appropriate in the public interest or for the protection of investors or consumers.

"(B) The order of the Commission under this paragraph granting any such exemption may impose such terms and conditions as the Commission finds are necessary to prevent an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under sections 6, 7, and 12.

"(4) With respect to the issuance of any security exempted from subsection (a), the Commission shall have authority to require by rule, regulation, or order, any registered holding company or any subsidiary company thereof to file, within thirty days or such later time as the Commission may prescribe, a certificate of notification of such issuance in such form and including such information as the Commission determines is necessary or appropriate in the public interest or for the protection of investors or consumers.

"DECLARATIONS BY REGISTERED HOLDING AND SUBSIDIARY COMPANIES IN RESPECT OF SECURITY TRANSACTIONS

"SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission regarding the issue of a security under subsection (a) of section 6, in such form and together with such information as the Commission may prescribe by rule or regulation.

"(b)(1) Except as otherwise provided in this subsection, a declaration filed under this section shall become effective on the twentieth day after the filing thereof unless the Commission prior to such effective date shall have issued a preliminary order to the declarant, together with a statement of its reasons—

"(A) disapproving such declaration; or

"(B) approving such declaration subject to terms and conditions.

If the declarant files notice with the Commission of its acceptance of a preliminary order subject to the terms and conditions imposed by the Commission, such preliminary order shall become final without further order or proceeding or opportunity for hearing, and the declaration shall become effective pursuant to such order upon the filing of such notice.

"(2) Within a reasonable time after the issuance of a preliminary order under paragraph (1), and after an opportunity on the part of the declarant for hearing upon such preliminary order, unless the declarant files with the Commission notice of the withdrawal of its declaration or notice of its acceptance of such preliminary order, the Commission shall enter a final order, together with a statement of its reasons—

"(A) approving such declaration;

"(B) disapproving such declaration; or

"(C) approving such declaration subject to terms and conditions.

"(3) A declaration filed under this section may be in the form of a general plan which may provide for the issue of a security or any class or classes thereof at such times as the declarant may determine to be appropriate over, or within, a period of twenty-four months or such longer period as the Commission by rules and regulations or order may allow.

"(4)(A) Amendments to a declaration may be made with the consent of the Commission or upon such terms and conditions as the Commission may, by rules and regulations or order, prescribe as consistent with the purposes of this section.

"(B) If an amendment to a declaration is filed prior to the twentieth day after filing of such declaration, unless the Commission shall, at the time such amendment is filed, consent to the filing thereof, the declaration shall not become effective until the later of the twentieth day after the filing of such declaration or the fifth day after the filing of such amendment.

"(5) The Commission may, by order, without requirement for an opportunity for hearing, upon application, having due regard for the public interest and the protection of investors and consumers, permit a declaration to become effective at a date earlier than the date upon which such declaration would otherwise become effective pursuant to paragraph (1) or subparagraph (B) of paragraph (4) of this subsection.

"(c) If a State commission or State securities commission having jurisdiction over any of the acts enumerated in subsection (a) of section 6 shall inform the Commission that State laws applicable to an act which is the subject of a declaration filed under this section have not been complied with, the Commission shall not permit such declaration to become effective unless and until the Commission is satisfied that such compliance has been effected, except that in the case of a declaration with respect to a plan filed under paragraph (3) of subsection (b), the Commission may condition its approval of the issuance of securities under the plan upon such compliance.

"(d)(1) Except as provided in subsection (c), the Commission shall permit to become effective a declaration regarding the issue of a security unless it finds that the acts which are the subject of the declaration involve an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under sections 6, 7, and 12.

"(2) If the Commission issues an order under subsection (b) disapproving a declaration regarding the issue of a security or approving such a declaration subject to terms and conditions, the order shall specify the unreasonable economic risk to investors or consumers which the Commission finds to be involved in the acts which are the subject of such declaration.

"(3) The authority of the Commission to impose terms and conditions under this section with respect to a declaration regarding the issue of a security shall be limited to those terms and conditions which it finds are necessary to prevent the unreasonable economic risk to investors or consumers set forth in the finding required by paragraph (2).

"(e) Any State commission having jurisdiction to regulate a public-utility company in a holding-company system of a registered holding company may, at any time prior to the effective date of a declaration filed in the form of a general plan under subsection (b)(3) by such registered holding company, or a subsidiary company thereof, request that the Commission extend the period for review of such declaration for an additional twenty days. If a State commission makes such a request, the declaration shall become effective on the fortieth day after the filing of such declaration unless the Commission issues an order prior to such date under subsection (b).".

PROVISIONS WITH RESPECT TO REGULATION OF CERTAIN DIVERSIFIED BUSINESS ACTIVITY

SEC. 8. The Public Utility Holding Company Act of 1935 is amended—

(1) in section 9 by striking subsection (a) and inserting in lieu thereof the following:

"SEC. 9. (a) It shall be unlawful—

"(1) for any registered holding company or any subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to acquire, directly or indirectly—

"(A) any securities of a public-utility company or a holding company or utility assets, unless such acquisition has been approved by the Commission under section 10; or

"(B) any significant interest in any business other than the public-utility business, unless there is in effect under section 10 a diversification plan for the holding-company system of which such holding company or subsidiary company is a part and such acquisition is consistent with such plan, or unless such acquisition has been expressly authorized by the Commission under section 10; or

"(2) for any person, by use of the mails or any means or instrumentality of interstate commerce, to acquire, directly or indirectly, any security of any public-utility company, if such person is an affiliate, under clause (A) of paragraph (11) of subsection (a) of section 2, of such company and of any other public-utility or holding company, or will by virtue of such acquisition become such an affiliate, unless the acquisition has been approved by the Commission under section 10; or

"(3) for any person that is not a registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to acquire, directly or indirectly, a security of a public-utility company if (A) the acquisition would make such person a holding company, and (B) such acquisition occurs other than pursuant to a plan initiated by such public-utility company, unless the acquisition has been approved by the Commission under section 10.";

(2) in section 9 by adding at the end thereof a new subsection to read:

"(d)(1) For the purposes of this section, the term 'significant interest' means an interest the net assets related to which as recorded on the books of the holding-company system would constitute (determined immediately after the acquisition of such interest by the holding-company system)—

"(A) 5 per centum or more of the total consolidated assets of the holding-company system; or

"(B) 10 per centum or more of the total consolidated assets of the holding-company system when taken together with the net assets as so recorded of all other interests acquired without Commission approval in any business other than the public-utility business.

"(2) For the purposes of clause (B) of paragraph (1) an interest acquired without Commission approval means an interest not—

"(A) acquired pursuant to an order under section 10 entered prior to the date of enactment of the Public Utility Holding Company Act Amendments of 1983;

"(B) acquired pursuant to a diversification plan in effect under section 10; or

"(C) expressly approved by the Commission under section 10 (including any interest not acquired by the holding-company system with the prior approval of the Commission, the acquisition of which by the holding-company system is thereafter approved by the Commission under section 10).";

(3) in section 10—

(A) by inserting after "securities" in paragraph (1) of subsection (a): "of a public-utility or holding company";

(B) by striking out in paragraph (3) of subsection (a) "other interest in any business, such information concerning such business and the interest to be acquired, and the consideration to be paid" and inserting in lieu thereof: "interest in any business other than the public-utility business, such information concerning such business and the interest acquired or to be acquired";

(C) by redesignating subsection "(b)" as paragraph "(b)(1)" and by redesignating paragraphs "(1)", "(2)", and "(3)" in paragraph (b)(1), as so redesignated, as clauses "(A)", "(B)", and "(C)", respectively;

(D) by amending as much of paragraph (b)(1), as so redesignated, as precedes clause (A), as so redesignated, to read as follows: "If the requirements of subsection (f) are satisfied, the Commission in the case of the acquisition of securities of a public-utility or holding company or utility assets shall approve the acquisition unless the Commission finds that—";

(E) by striking out in clause (b)(1)(B), as so redesignated: "in case of the acquisition of securities or utility assets,";

(F) by adding at the end of subsection (b) a new paragraph (2) to read as follows:

"(2) The Commission shall approve any application filed under this section for the acquisition of an interest in any business other than the public-utility business, unless the Commission finds that such acquisition is likely to—

"(A) result in an unnecessary and unreasonable increase in costs to consumers; or

"(B) impair the performance by any associate company which is a public-utility company of its public-utility service in a manner which is inconsistent with the service obligations of such company under applicable State law.";

(G) in paragraph (1) of subsection (c) by striking out "or utility assets, or of any other interest," and inserting in lieu thereof: "of a public-utility or holding company or utility assets";

(H) in paragraph (2) of subsection (c) by striking out "or utility assets of a public-utility or holding company" and inserting in lieu thereof: "of a public-utility or holding company or utility assets";

(I) by redesignating subsection "(e)" as paragraph "(e)(1)", by inserting after "securities" the first time it appears in paragraph (e)(1), as so redesignated, "of a public-utility or holding company", and by adding at the end of such subsection a new paragraph (2) to read as follows:

"(2) A registered holding company or any subsidiary company thereof may apply for the removal or modification of any terms and conditions prescribed in an order issued prior to the enactment of the Public Utility Holding Company Act Amendments of 1983 approving the acquisition of an interest in any business other than the public-utility business by filing an application under this subsection in such form as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. Any such application shall be deemed approved on the sixtieth day after the filing thereof, unless the Commission, acting upon its own motion or upon the request of a State commission having jurisdiction to regulate a public-utility company in the holding-company system involved, by order issued prior to such day, shall determine that the removal or modification which is the subject of such application is likely to—

"(A) result in an unnecessary and unreasonable increase in costs to consumers; or

"(B) impair the performance by any associate company which is a public-utility company of its public-utility service in a manner which is inconsistent with the service obligations of such company under applicable State law.";

(J) by inserting after "acquisition" when it occurs the first time in subsection (f): "of securities of a public-utility or holding company or utility assets"; and

(K) by adding at the end thereof new subsections to read as follows:

"(g)(1) A registered holding company may file with the Commission a diversification plan, in such form as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers, providing information with respect to its intentions within two years from the date of such filing to diversify into businesses other than the public-utility business. Any such plan shall set forth, in addition to a statement of the intentions of the holding company with respect to diversification, statements describing the intended relationship, if any, between any such other businesses and the public-utility business of the holding-company system of such holding company, the proposed method of financing such other business interests and their acquisition, and the expected relationship between the aggregate of the investment in other business activities and investment in the public-utility business of such system. Amendments to a diversification plan may be made upon such terms and conditions as the Commission may by rules and regulations or order prescribe as consistent with the purposes of this subsection.

"(2)(A) A diversification plan filed with the Commission under this subsection shall take effect on the sixtieth day after the filing thereof, unless the Commission, acting on its own motion or upon the request of a State commission having jurisdiction to regulate a public-utility company in the holding-company system involved, prior to such effective date shall have issued an order to the registered holding company, together with a statement of its reasons, disapproving the diversification plan.

"(B) Any State commission having jurisdiction to regulate a public-utility company in a holding-company system of a registered holding company may, at any time prior to the effective date of a diversification plan filed by such registered holding company, request that the Commission extend the period for review of such plan for an additional forty-five days. If a State commission makes such a request, the diversification plan shall become effective on the one hundred and fifth day after the filing of such plan unless the Commission issues an order prior to such date disapproving such plan pursuant to paragraph (3).

"(3) The Commission shall permit a diversification plan filed under this subsection to become effective unless it finds that the actions or activities to be undertaken pursuant to such plan are likely to—

"(A) result in an unnecessary and unreasonable increase in costs to consumers; or

"(B) impair the performance by any associate company which is a public-utility company of its public-utility service in a manner which is inconsistent with the service obligations of such company under applicable State law.

"(h) An application filed with the Commission under this section for express approval of the acquisition of an interest, acquired or to be acquired, in any business other than the public-utility business shall be deemed approved on the sixtieth day after the filing thereof, unless the Commission, acting upon its own motion or upon the request of a State commission having jurisdiction to regulate a public-utility company in the holding-company system involved, by order entered prior to such day shall determine that the acquisition which is the subject of such application is likely to—

"(1) result in an unnecessary and unreasonable increase in costs to consumers; or

"(2) impair the performance by any associate company which is a public-utility company of its public-utility service in a manner which is inconsistent with the service obligations of such company under applicable State law.";

(4) in section 11(a)—

(A) by striking out "necessary or"; and

(B) by striking out "the operations of";

(5) in section 11(b)—

(A) by striking out ", as soon as practicable after January 1, 1938";

(B) by amending paragraph (1) to read as follows:

"(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are appropriate to such integrated public-utility system: *Provided, however,* That—

"(A) the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

"(i) each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

"(ii) all of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

"(iii) the continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation; and

"(B) The Commission shall permit as appropriate to an integrated public-utility system the retention of an interest in any business (other than the public-utility business) unless the Commission by order shall determine, by specific factual findings made upon clear and convincing evidence, that the retention of such interest materially adversely affects the public-utility business of such system."; and

(C) by adding at the end thereof the following new paragraph:

"(3) Notwithstanding any other provision of this title, the Commission shall permit a registered holding company to retain any combination in existence on May 1, 1981, of gas utility systems and electric utility systems unless the Commission finds, after notice and opportunity for hearing, that the combination of systems fails to satisfy the requirements of subclauses (ii) and (iii) of clause (A) of paragraph (1).";

(6) in section 11(e) by striking out ", at any time after January 1, 1936,"; and

(7) in section 11(g) by striking out "or otherwise," where it appears the second time.

TRANSACTIONS WITH ASSOCIATE COMPANIES AND AFFILIATES THEREOF

SEC. 9. Section 12 of the Public Utility Holding Company Act of 1935 is amended to read as follows:

"DIVIDENDS AND OTHER TRANSACTIONS

"SEC. 12. (a) It shall be unlawful for any registered holding company or for any subsidiary company thereof which is a public-utility company, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to declare or pay any dividend on any security of such company or to acquire, retire, or redeem any security of such company, in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate to protect the financial integrity of public-utility companies in holding-company systems, to safeguard the working capital of public-utility companies, to prevent the payment of dividends out of capital or unearned surplus, or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.

"(b) It shall be unlawful for any registered holding company which is a public-utility company or any public-utility company which is a subsidiary company of a registered holding company, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly, to lend or in any manner extend its credit to or indemnify any company in the same holding-company system or enter into any other financial transaction with any company in the same holding-company system in contravention of such rules and regulations or orders as the Commission deems necessary either to prevent an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under sections 6, 7, and 12, or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.

"(c) It shall be unlawful for any registered holding company, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to sell any security which it owns of any public-utility company, or any utility assets, in contravention of such rules and regulations or orders regarding the consideration to be received for such sale, maintenance of competitive conditions, fees and commissions, accounts, disclosure of interest, and similar matters as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.

"(d) It shall be unlawful for any affiliate or associate company of any registered holding company or any subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, to negotiate, enter into, or take any step in the performance of any transaction not otherwise unlawful under this title, with any company which is a public-utility company and with which it is an affiliate, or with respect to which it is an associate company, in contravention of such rules and regulations or orders regarding reports, accounts, costs, maintenance of competitive conditions, disclosure of interest, duration of contracts, and similar matters as the Commission deems necessary for the protection of investors or consumers or to prevent the circumvention of the provisions of this title or the rules, regulations, or orders thereunder.

"(e) The Commission shall not have authority to prohibit under this section:

"(1) any sale of utility assets used or operated by a public-utility company in a holding-company system if the State commission of the State in which such assets are located expressly authorizes such sale; or

"(2) any transaction with a public-utility company expressly authorized, or deemed approved under applicable law, by the State commission of each State in which such public-utility company is doing business, as such.".

SERVICE, SALES, AND CONSTRUCTION CONTRACTS

SEC. 10. Section 13 of the Public Utility Holding Company Act of 1935 is amended—

(1) in subsections (a) and (b) by striking out "After April 1, 1936, it" and inserting: "It";

(2) in subsection (g) by striking out the subsection; and

(3) by adding at the end thereof the following new subsections:

"(g) For the purposes of this title, the costs to be charged to an associate company by any subsidiary company of a registered holding company with respect to the performance of any sales, service, or construction contract shall be determined—

"(1) on the basis of the costs fairly and equitably allocated to the performance of such contract; and

"(2) without regard to any earnings or losses fairly and equitably attributable to the performance of any contract or other transaction with any person which is not an associate company of such registered holding company.

"(h) Notwithstanding any other provision of this title, the Commission may, by order, upon application by a registered holding company or any subsidiary company thereof, if it determines that such action is consistent with the public interest and the protection of investors or consumers, permit a subsidiary company of a registered holding company to perform any—

"(1) sales contract;

"(2) service contract (other than a contract for the performance of management, supervisory, accounting, legal, or financial services); or

"(3) construction contract;

for an associate company at a price (or pursuant to a method of pricing which results in a price) which may be in excess of the costs of such subsidiary company: *Provided, however,* That the Commission determines that means are available by contractual terms, or otherwise, to assure that such price will be no greater than the price of comparable contracts performed by persons who are not associate companies or, in the case of a contract for the sale of goods, not greater than the market price of such goods.".

OFFICERS, DIRECTORS, AND OTHER AFFILIATES

"SEC. 11. Sections 16 and 17 of the Public Utility Holding Company Act of 1935 are amended as follows:

(1) in subsection (b) of section 16 by striking out ", except as provided in section 17(b),"; and

(2) in section 17 by amending the section to read as follows:

"OFFICERS AND DIRECTORS

"SEC. 17. The Commission shall have authority by order, giving due consideration to the evolving nature of financial institutions, to prohibit any person from serving as an officer or director of a registered holding company or any associate company if such person is an officer or director of any investment banker or investment banking association, or of any bank, trust company, or banking association or firm that is authorized by law to underwrite or participate in the marketing of securities (other than commercial paper) of a public-utility company, if the Commission finds that such prohibition is essential to safeguard the interests of consumers and that means are not otherwise available to safeguard such interests.".

CONFORMING CHANGE TO SECURITIES ISSUANCE PROCEDURES

SEC. 12. Subsection (c) of section 20 of the Public Utility Holding Company Act of 1935 is amended by striking out "Orders" in the last sentence and inserting in lieu thereof "Except as provided in section 7, orders".

STUDY OF PUBLIC-UTILITY AND INVESTMENT COMPANIES

SEC. 13. The last sentence of section 30 of the Public Utility Holding Company Act of 1935 is repealed.

NOTICE TO STATE COMMISSIONS

SEC. 14. The Public Utility Holding Company Act of 1935 is amended by adding a new section to read:

"NOTICE TO STATE COMMISSIONS

"SEC. 34. Any holding company that files an application for exemption under section 3(a) and any registered holding company, or subsidiary company thereof, that files a declaration in the form of a general plan pursuant to section 7(b)(3), an application for approval of a diversification plan under section 10(g), or an application for approval of the acquisition of an interest in any business under section 10(h) shall, at the time of such filing, give contemporaneous notice of such application or declaration, in such form as the Commission may prescribe, to each State commission having jurisdiction to regulate a public-utility company in the holding-company system of such holding company or such registered holding company.".

With that, I will call the first witness, Mr. Freedman. We are delighted you could be here once again, Mr. Freedman.

STATEMENT OF SOLOMON FREEDMAN, COUNSEL, JACOBS, PERSINGER & PARKER, WASHINGTON, D.C.

Mr. **Freedman**. Mr. Chairman, I was requested to appear here by you, and as my statement says, I am not representing anybody, and I am here basically to give the history and the background of the act.

I came to the SEC in 1942, and became Assistant Director of the then Division of Public Utilities in 1951, Associate Director in 1961, and Director in 1964, and I resigned in 1972. So I have had a period of 30 years in which one of the important functions of the division was helping the Commission in the administration of the Public Utility Holding Company Act.

In my statement I have set forth the background of the act, the fact that there were two exhaustive studies made with respect to the public utility industry and the evils that the two committees discovered in connection with the public utility industry, and the fact that the Holding Company Act was enacted to cure those evils, and hopefully to make sure that they would not occur again.

So I won't repeat what is in my prepared statement.

I thought at the beginning of these hearings it might be helpful if the committee had a background as to how the act operates.

BACKGROUND

This act is basically concerned with only two kinds of utilities, (1) electric utility companies, and (2), gas utility companies. An electric utility company is defined as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale,", and a gas utility company is defined as "any company which owns or operates facilities used for the distribution at retail of natural or manufactured gas for heat, light, or power."

You can see that the definition of a gas utility company is more restrictive than that of an electric utility company, so that a natural gas pipeline company is not a gas utility under this act and therefore is not a public utility company.

A company that owns or holds 10 percent or more of the voting securities of a public utility company is a "holding company," and any company 10 percent or more of whose voting securities are owned or held by a holding company is a "subsidiary company" of such holding company.

Those definitions are all in section 2 of the act.

Section 3 relates to the granting of exemptions to five different kinds of holding companies. I notice the bill proposes the addition of a sixth.

Section 4 makes it unlawful for a holding company, unless it registers as a holding company under section 5, to, among other things, transmit electric energy or distribute gas in interstate commerce, or to offer or sell any security by any means of the mails or any instrumentality of interstate commerce.

Sections 6 and 7 concern the issue and sale of securities by any holding company or any subsidiary. A company which desires to issue or sell any security must file a declaration with the Commission, and before it may sell such a security, the Commission must enter an order permitting the declaration to become effective.

Section 7 sets forth the standards which must be satisfied before the Commission may permit the declaration to become effective. Among the standards is section 7(d) which requires the declaration to be denied if the security is not reasonably adapted to (a) the security structure of the declarant and other companies in the same holding company system, and (b) the earning power of the company.

There is a provision, section 6(b) which requires the Commission to permit, subject to terms and conditions, the declaration of a public utility company to become effective if the State commission where such company is organized and is doing business expressly authorizes the issuance and sale.

SEC JURISDICTION

Thus while the act recognizes that a State public utility commission has appropriate jurisdiction with respect to securities issued by local public utilities, it is also recognized that a State commission has no jurisdiction as to a pure holding company. Only the SEC has such jurisdiction.

Thus, since at least three of the present gas utility holding company systems finance their operations virtually entirely, if not solely, at the holding company level and no public utility company subsidiary issues and sells securities, no State commission has any jurisdiction over such issuances and sales.

Under section 7(f) the Commission may impose terms and conditions as to the issuance and sale of the security. Under this section, and section 6(b) that I just mentioned, the Commission in 1956 adopted minimum standards required for the protection of investors, to be included in first mortgage bond indentures and preferred stock charters.

Also under this section the Commission in 1941 adopted the competitive bidding rule which requires that, unless an exemption is given, the public utility is required to sell its securities by virtue of public bidding.

Now section 11, particularly section 11(b), has been said to be the heart of the act. It has two paragraphs. Under paragraph 1, the Commission has the duty to require each registered holding company to take appropriate action to limit the operations of the holding company system to a single "integrated public utility system," and to such other businesses as are reasonably incidental to the operations of such system, and to such additional integrated systems that satisfy certain standards. The term "integrated public utility system" is defined in section 2(a)(29), one definition for an electric utility system, and one definition for gas utility companies. Thus, a gas system and an electric system are two separate systems, they cannot together be a single integrated system.

Under paragraph 2 of section 11(b) the Commission has the duty to require each registered holding company and each subsidiary thereof to take appropriate action to (a) insure that the corporate structure or continued existence of any company in the system does not complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such system; and (b) limit the number of holding companies in any system so that there can be only two holding companies above any public utility company in the system, the so-called "great grandfather provision."

The remainder of section 11 deals with the enforcement of orders of the Commission under section 11(b) or plans submitted by companies to comply with the provisions of section 11(b); and proxies for approval of such plans.

Closely related to section 11(b) are sections 9 and 10 of the act. Generally speaking, under section 9 no registered holding company or subsidiary thereof may acquire any securities or utility assets or any other interest in any business unless approval is first obtained from the Commission. Section 10 sets forth the standards for approval.

Section 10(b) requires the Commission to approve such acquisition unless (1) it will tend toward interlocking relations or improper concentration of control of public utility companies, (2) the consideration to be paid is not reasonable, and (3) it will unduly complicate the capital structure of the holding company system or its proper functioning. Those are the standards that the Commission must find. The burden of proof is on the Commission before it can deny the application.

Section 10(c) provides the Commission shall not approve any acquisition (1) which the Commission finds is detrimental to the carrying out of the provisions of section 11, and again the burden is on the Commission, or, (2) unless the Commission finds it will serve the public interest by tending toward the economical and effficient development of an integrated public utility system. Here the burden is on the applicant, not on the Commission.

Thus sections 9 and 10 act as measures to prevent the reoccurrence and re-creation of the situations which are eliminated by the enforcement of section 11.

The rest of the act deals with such things as intercompany loans, indemnification and the like, and they are all set forth in my statement.

Section 13 deals with service, sales and construction contracts.

Section 14 deals with reports to the Commission. Section 16 makes it unlawful to file a false or misleading statement with the Commission.

Then we get to section 17(a) which deals with reports to the Commission by officers and directors of companies in registered holding company systems. Section 17(b) is a counterpart of section 16(b) of the Securities Exchange Act of 1934. Section 17(c), as you know, prohibits any representative of any bank, trust company, investment banker or banking association from being an officer or director of any registered holding company or subsidiary thereof. This is a prophylactic provision to prohibit the determination of the financial activities of companies in registered holding companies to be made by persons personally interested in obtaining contracts for such activities. It must be remembered that holding company systems and utility companies generally issue and sell securities probably more often than any other industry. This section assures that decisions as to what and when securities are to be sold will be determined by persons having allegiance solely to the needs of the companies.

Now the act is regulatory in nature. It prohibits certain kinds of transactions and requires Commission approval of a variety of activities. The Commission is required to make financial and economic decisions. This is unlike the Securities Act of 1933, which relates almost entirely to disclosure in the sale of securities to the public, and unlike the Securities Exchange Act of 1934, which deals generally with reports required to be filed with the Commission by public companies; it prohibits manipulation and fraud in the sale of securities; it requires a full and fair presentation of financial statements by publicly held companies. It requires information be disclosed in take-over efforts; it requires disclosure of facts in proxy statements, and of course the Commission has oversight of self-regulatory associations, the trading markets, clearing agencies and transfer agents.

SETTING OF RATES

Under the Holding Company Act the Commission is not involved in the setting of rates. That is a misconception. A lot of people think it does. It does not. At the local level, the State public utility commissions set the rates and the rates for electricity carried from one State to another and the rates for the transportation of natural gas across State lines are determined by the Federal Energy Regulatory Commission. As indicated, the State regulatory commissions have no jurisdiction over the activities of the holding company. This is particularly true when the holding company is incorporated in a State in which none of its subsidiary public utilities operate. There is no way, for instance, for the State in which the subsidiary utility operates to obtain the books and records of the holding company.

Senator D'Amato. This might be a good point, Mr. Freedman, for us to have a little dialog.

Let me thank you for taking the time not only today, but at the previous hearings, to come in and lay the foundation in terms of what the purpose of the act is and why it was enacted.

LOCAL REGULATORS TO HAVE ACCESS TO RECORDS

But let me ask you this: In S. 1174 we provide that the local regulators for the first time will have access to the books, records, and other information. I must say that it was something of a concession from the utility companies, that this information relating to nonutility activities be made available to the local regulators.

Isn't that an improvement over the 1935 act?

Mr. Freedman. The provision in the bill——

Senator D'Amato. S. 1174.

Mr. Freedman. S. 1174 is a good provision.

Senator D'Amato. Good.

Mr. Freedman. I won't put it that way. But, as I understand it, under the Holding Company Act, as far as companies in holding company systems are concerned, the information that the State commission can get is required to be filed with the SEC, or the SEC can get it under this act.

Senator D'AMATO. That is not necessarily true. Because there really is a problem of getting these records to the local jurisdictions. S. 1174 provides specifically that they are going to have direct access to these records. To reiterate this has come about as a result of intensive negotiations in the past year between the holding company people and the regulators. Isn't this an improvement?

Mr. FREEDMAN. Sure.

Senator D'AMATO. Also, doesn't S. 1174 relax some of the onerous provisions of the act? Under S. 1174 we provide for a system of shelf registration, where a registered utility holding company files a plan and then is permitted to go to the market with their security when the market conditions are best. Obviously utilities are trying to raise capital they can capitalize on fluctuations in the market and can get the lowest interest rates.

Don't you think that that is superior to having to go to the SEC, hence being held up, and don't the provisions of the 1933 and 1934 act, give adequate protection to investors?

Mr. FREEDMAN. I am glad you brought that out because I was going to get to it.

Senator D'AMATO. I knew that. So I figured we could expedite the proceedings.

Mr. FREEDMAN. Under the rule and a release of the Commission, what is objected to in connection with the issuance and sale of securities by public utility companies can be accomplished to the same extent as is proposed in this bill. You don't need this bill to do what is said to be objectionable. A public utility company now can have shelf registration under rule 415 and it can give the Commission a program over an indefinite period of time in the future. Of course you don't want it to go 150 years or maybe not even as long as the rule against perpetuity. But if they lay out their financial program over a reasonable period in advance, they get Commission approval and they can go to the market any time they want. So the bill is OK, but you don't need it.

Senator D'AMATO. Doesn't it make the act clearer, by spelling out the procedures and less onerous by cutting down on the time necessary to have a plan approved?

Mr. FREEDMAN. No. If you look at—I happen to have the SEC Docket here, and the citation is 27 SEC Docket, page 1190. It sets forth an application by Middle South Utilities, which wants to sell 10 million authorized but unregistered shares of its common stock. It lays out the whole program, how it is going to do it. It can do it in a number of different ways, including selling it on exchanges, selling it through competitive bidding, even selling it by way of negotiations if they get an exemption from the Commission, if the other two don't work.

So there wasn't even a hearing ordered by the Commission on this. So that while the bill would put it in the statute, it is unnecessary. That is my only point.

Senator D'AMATO. You now have concluded that two provisions of S. 1174 are not bad. You agreed our first suggestion is good, and the second, you say, is not necessary. I will take 50 percent.

Mr. **Freedman**. Wait a minute. Your batting average is going to go down.

Senator D'**Amato**. Oh, I know that.

AMENDING PROVISIONS RELATING TO EXEMPTIONS

Mr. **Freedman**. Well, there are one or two points that I thought I ought to make after looking at this bill. I haven't studied it extensively, but one of the things that is said in connection with amending the provisions relating to the revocation of an exemption, the argument is made that under the present act the Commission can revoke the exemption retroactively. That is simply not true. The last sentence of section 3(c) says the Commission can revoke the exemption if the circumstances which gave rise to the order no longer exists. It doesn't say anything about making the revocation retroactive. Also section 20(d) in the last sentence says "Any act done or admitted in good faith in conformity with any order of the Commission can not be attacked, notwithstanding that such order may be rescinded." You can't do this retroactively.

Also under the bill—here is the part that is amusing to me—an exemption can not be denied or revocation entered unless the Commission shows that the exemption would, upon clear and convincing evidence, materially adversely affect the public utility business of such holding company system.

The nature of the proof must be clear and convincing. That is a new standard. Generally, it is just the preponderance of the evidence. As a matter of fact, the Commission, in a case that went to the Supreme Court in connection with the standards of the Investment Company Act and Advisory Act, resisted the requirement of clear and convincing. That case is recorded as *SEC* v. *Steadman,* 450 U.S. 91 (1981). The provision in the bill says "affect the public utility business." That is a new concept. The act states the exemption may be denied if it is "detrimental to the public interest or the interest of investors or consumers".

Senator D'**Amato**. That is kind of broad, isn't it?

Mr. **Freedman**. No, because you go back to section 1, and see what is meant by those things. Now you throw in another thing, affect the public utility business. I don't know what that means. Then you get to section 11(b)(1), which is the requirement that the system has to be in only one business, that of being an integrated public utility system, and such other business as, in effect, is functionally related to the operations of that system.

This bill would permit the retention of any interest in any business other than public utility business unless the Commission finds by specific findings made upon clear and convincing evidence that the retention of such interests materially adversely affect the public utility business of such system.

There are about five tricky words that the Commission must find.

Senator D'**Amato**. Adversely, clear and convincing——

Mr. **Freedman**. Specific findings.

Senator D'**Amato**. Shouldn't there be a specific finding?

Mr. **Freedman**. Yes.

Senator D'AMATO. You don't have any difficulty with that, do you?

Mr. FREEDMAN. You don't need it. The Administrative Procedure Act requires it.

Senator D'AMATO. So you don't find anything objectionable about saying it should be specific?

Mr. FREEDMAN. No. OK.

Senator D'AMATO. Let's analyze this step by step because you said there are five tricky things. First, you brought up the word "specific", What is wrong with making a specific finding?

Mr. FREEDMAN. Nothing.

Senator D'AMATO. That's right. It is not in the best interests of society to have generalizations, where people can just tar and feather others. One of the great problems is utilities are hated, so it is easy to come out and whack them over the head. Therefore if we are going to charge them with something, and prove they did something wrong the findings should be "specific" and "adverse"? You have indicated that we should have dialog with regard to these matters. I realize we didn't set up this hearing up so that we would have everyone come in and say it is wonderful. I want to know where things are wrong. We started the process last year and we have come a long way since then. I said last year we are not wedded to anything, and I say it again today. I am deeply appreciative of the time you have given, particularly since you don't have a special interest in the legislation. You don't represent anyone, you make your statements based on your long years of experience in administering this act and I am appreciative of that. Now, after examining this particular language, what is wrong with "clear"?

Mr. FREEDMAN. Nothing. But what it modifies is important. You have to find upon clear and convincing evidence, the standard of proof, the retention of such interests materially adversely affects the public utility business of such system.

The present standard is the Commission will find retention is necessary, appropriate, in the public interest or for the protection of investors and consumers. The bill turns the burden of proof upside down.

Senator D'AMATO. Sure.

Mr. FREEDMAN. And requires the Commission to show the retention materially affects adversely the public utility business.

Senator D'AMATO. Isn't that as it should be?

Mr. FREEDMAN. No.

Senator D'AMATO. Shouldn't they demonstrate clearly that it has an adverse impact on the public utility business and therefore should not be permitted? The issue is whether or not we should permit diversification and under what ground rules. Therefore, what criteria do we use?

Mr. FREEDMAN. It depends upon how you look upon it as to who should have the burden of proof. This requires the Commission to do it. In my opinion it is a kind of proof that is very very difficult, if not impossible, for the Commission to make all of these detailed—not detailed— but the kind of findings, the nature of it, "materially adversely."

Senator D'AMATO. I will ask the counsel for the committee, people who testify after you and our staff to look at this again and maybe we will provide you with some additional questions.

Mr. FREEDMAN. I was going to make a crack, but I won't.

Senator D'AMATO. No, you can make a crack. Go ahead.

Mr. FREEDMAN. I was going to say this is the kind of standard that is like requiring the Commission to make a finding that there is life hereafter, and to prove it by clear and convincing evidence.

Senator D'AMATO. That is not quite true. Under the 1935 act the qualified utility automatically receives an exemption and the burden of proof is on the SEC to revoke that.

CONSERVATIVE STATUTE

Mr. FREEDMAN. I am talking about section 11(b).

I just want to finish by pointing out two things. One is that this statute is a very conservative statute.

Senator D'AMATO. What do you mean by that?

Mr. FREEDMAN. Because it does not permit the companies that are in a very important business to operate willy-nilly as they wish.

Senator D'AMATO. Other businesses?

Mr. FREEDMAN. They can't be a conglomerate.

Senator D'AMATO. Mr. Freedman, the days of the great utility companies with great profits are disappearing. We find them now in deep financial trouble. Furthermore I think we had better recognize that unless we give them the ability to make timely business decisions and to diversify, then the public is going to pay increasingly high rates which will create economic stress for those who simply can't afford these exorbitant rates.

I don't suggest that this bill is a cure-all. One of the great problems—this act has not dealt with is illegal cross-subsidization whereby a utility goes into a related business and drives out the competition, by allocating the costs of the nonutility business to its utility and its ratepayers. Therefore, I am deeply concerned about this problem as it relates to plumbing, heating, ventilation, and other similar businesses. The fact of the matter is the act as it presently stands does not prevent this ongoing problem. I want to see fair competition. I don't want to give the utilities the ability to drive out the small independent contractors by cross-subsidization. We have yet to develop to my satisfaction, as this proposed legislation stands, the criteria which would guard against that problem.

So while I recognize S. 1174 is not perfect, I want to suggest to you that maybe we have reached a point in the history of utility holding companies where we had better begin to give them additional flexibility and the ability to finance other operations in a manner that gives them greater breadth. Certainly, as a procedural matter they shouldn't have to go to the SEC to buy, lease, or sell something, when the decision to do so is a prudent business judgment. I think that is absolutely horrendous. I don't think you would defend that, either.

Mr. FREEDMAN. Do you want me to respond?

Senator D'AMATO. Well, I am just stating my concerns.

Mr. FREEDMAN. I think that the way you express it, a public utility company, registered holding company system, cannot go into the plumbing business as such.

PROTECTION AGAINST UNFAIR SUBSIDIZATION

Senator D'AMATO. Well, you will hear testimony later by contractors that expresses that concern, in terms of the various energy conservation programs that utilities are running. Many of them believe that utilities should be precluded from entering any of these related businesses. Unless cross-subsidization is effectively terminated.

Mr. FREEDMAN. I agree, there shouldn't be any unfair subsidization. I thought this act prevented it.

I think it is important for my friends in the public utility industry to recognize that this act is the greatest protection against takeovers that ever existed.

Senator D'AMATO. Nobody wants to take them over. You would have to be crazy to take over these public utilities. If an officer of any major corporation proposed such a takeover they would probably throw him out.

Mr. FREEDMAN. I read in the Wall Street Journal yesterday that one public utility company is proposing to take over another public utility company.

Senator D'AMATO. All right. That is like the banks. When they merge with one another. Of course, Mr. Freedman I am being a little facetious.

Mr. FREEDMAN. But if I were the manager and were concerned about the possibility of a takeover, then I would be very comfortable with having this act, because three things have to happen before you can even make the offer. First you have to file the application with the SEC and that becomes public knowledge. And as I understand it, that is bad for the takeover company. Second, before you can make the offer, you have to get approval of the Commission. And third, the Commission must find that the acquisition will tend toward the economic development of an integrated public utility system.

So some person that, or a company that isn't even in the public utility business, if they want to take over a registered holding company system, they would have a great deal of trouble getting approval of the Commission.

Senator D'AMATO. That bell means there is a vote on the floor.

Mr. FREEDMAN. I am finished.

Senator D'AMATO. I told them to schedule it at this time. I didn't want you to bring up the other points of disagreement.

[The prepared statement of Mr. Freedman follows:]

INTRODUCTION

My name is Solomon Freedman and I am of counsel to the legal firm of Jacobs, Persinger and Parker. Neither my firm nor I represent any public utility holding company, any public power group or any cooperative. We do not represent anyone that would be affected by S. 1174. I was invited to appear by the staff of the subcommittee.

As background, I joined the staff of the Public Utilities Division of the Securities and Exchange Commission in 1942. That Division aided the Commission in the administration of the Public Utility Holding Act of 1935 ("Act"). I became Assistant

Director in 1951, Associate Director in 1961 and Director in 1964. I resigned in 1972. I was thus deeply involved in the administration of this Act for a 30-year period. During this period, the Division was given additional responsibilities and had its name changed.

BACKGROUND

The Public Utility Holding Company Act of 1935 was enacted as a consequence of two investigations of the electric and gas utility industry—one by the Federal Trade Commission upon the direction in 1928 of the Senate, and the other by the House Committee on Interstate and Foreign Commerce.

The Federal Trade Commission report consisted of some 90 volumes and has been said to be the most exhaustive study, at least up to that time, of any industry. The House Committee report constituted six volumes.

These studies uncovered a number of abuses in holding company systems: (1) the holding company was used to acquire control of operating public utility companies with the holding company issuing its senior securities to the public and the promoters retaining the voting securities. As a result the holders of the common stock of the top holding company, with a relatively small investment, controlled all the utility companies, (2) holding company was piled on top of other holding companies with each tier issuing its own senior securities so that all the senior securities in each tier were dependent entirely on the common stock earnings of the public utilities which were at the bottom of the pyramid. Sometimes there were six or seven tiers of holding companies.

As a consequence, a slight reduction in the earnings of the public utilities would have a devastating effect upon the ability of each holding company to pay its own debt and preferred stock requirements. This device thus resulted in complex corporate structures almost impossible for the average investor, or even sophisticated securities analysts, to fathom. It also resulted in an unfair distribution of voting power in that the holders of the common stock, with a relatively small investment, controlled all the other companies in the system.

Another evil was the holding by the holding company of public utilities in widely separated parts of the country with no operating relationships between them. Thus some of the systems controlled public utilities as widely separated as the Pacific Coast and the East Coast; along with other utility companies in the middle west and southern states, and even in foreign countries. While these scattered holdings were attempted to be justified on the basis of diversification of risk and of the advantage of centralized management and purchasing, the studies indicated these were not meaningful advantages and Congress did not accept them.

A further evil was the presence in holding company systems of properties that had no relationship whatsoever with the operation of the public utility companies. Thus, in one system, there were water distribution companies, street railway companies, bus companies, ice companies, a ferry company, a hotel company, sewage companies, real estate companies and even a college.

Further, these empires were generally created by investment bankers who were interested in obtaining underwriter fees from the issuance of securities by each segment of the holding company system and not with an eye as to whether or not the companies were adequately capitalized or whether the companies could generate enough earnings to satisfy their fixed charges.

THE STRUCTURE OF THE ACT

The act is basically concerned with only certain kinds of public utilities: (1) electric utility companies, and (2) gas utility companies. An "electric utility company" is defined as "any company which owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale" (Sec. 2(a)(3)). A "gas utility company" is defined as "any company which owns or operates facilities used for the distribution at retail * * * of natural or manufactured gas for heat, lights, or power" (Sec. 2(a)(4)). Thus, a natural gas pipeline company is not a gas utility company.

If a company owns or holds 10 percent or more of the voting securities of a public-utility company, it is a holding company (Sec. 2(a)(7)), and any company, 10 percent or more of whose voting securities are owned or held by a holding company is a "subsidiary company" of such holding company (Sec. 2(a)(8)).

Section 3 relates to the granting of exemption to five different kinds of holding companies; section 4 makes it unlawful for holding company, unless it registers as a holding company pursuant to Section 5, to, among other things, for it or any subsidiary thereof, to transmit electric energy or distribute gas in interstate commerce, or to offer or sell any security by any means of the mails or any instrumentality of interstate commerce.

Sections 6 and 7 concern the issue and sale of securities by any holding company or subsidiary company thereof. A company which desires to issue or sell any security must file a declaration with the Commission for such issue and sale and, before it may sell such security, the Commission must enter an order permitting the declaration to become effective. Section 7 sets forth the standards which must be satisfied before the Commission may permit the declaration to become effective. Among these standards is section 7(d) which requires the declaration to be denied if the security is not reasonably adapted to (a) the security structure of the declarant and other companies in the same holding company system; or (b) the earning power of the declarant.

Section 6(b) requires the Commission to permit, subject to terms and conditions, the declaration of a public-utility company to become effective if the State commission where such company is organized and doing business expressly authorizes the issuance and sale. Thus, while it is recognized that a State public utility commission has appropriate jurisdiction with respect to securities issued by local public utilities, it is also recognized that a State Commission has no jurisdiction as to holding companies. Only the S.E.C. has such jurisdiction. Thus, since at least three of the present gas utility holding company system finance their operations solely at the holding company level, and no public utility company subsidiary issues and sells securities, no State commission has any jurisdiction over such issuances and sales.

Under Section 7(f) the Commission may impose terms and conditions to the issue and sale of the security. Under this section, and the correlative Section 6(b) (which concerns securities of public-utility companies authorized by a State public utility commission), the Commission in 1956 adopted minimum standards required for the protection of investors, to be included in first mortgage bond indentures and preferred stock charters.

Section 11, particularly Section 11(b) has been said to be the "heart of the Act." Under paragraph (1) the Commission has the duty to require each registered holding company system to take appropriate action to limit the operations of the holding company system to a single "integrated public-utility system" and to such other businesses as are reasonably incidental to the operations of such system; and to such additional integrated systems as satisfy certain standards. The term "integrated public-utility system" is defined in Section 2(a)(29)—one for electric utility companies and one for gas utility companies. Thus, a gas system and an electric system are two separate systems. They cannot, together, be a single integrated system.

Under paragraph (2) of Section 11(b), the Commission has the duty to require each registered holding company, and each subsidiary company thereof, to take appropriate action to (a) ensure that the corporate structure, or continued existence of any company in the system, does not complicate the structure, or unfairly or inequitably distribute voting power among security holders of such system; and (b) limit the number of holding companies in any system so that there can be only two holding companies above any public utility company in the system—the so-called "great grandfather provision."

The remainder of Section 11 deals primarily with the enforcement of orders of the Commission under Section 11(b), or plans submitted by companies to comply with the provisions of Section 11(b) and proxies for approval of such plans.

Closely related to Section 11(b) are sections 9 and 10 of the Act. Generally speaking, under section 9, no registered holding company or subsidiary thereof may acquire any securities or utility assets or any other interest in any business unless approval is first obtained from the Commission. Section 10 sets forth the standards for approval.

Section 10(b) requires that the Commission approve such acquisitions unless (1) it will tend toward interlocking relations or improper concentration of control of public-utility companies, (2) the consideration to be paid is not reasonable, or (3) it will unduly complicate the capital structure of the holding company system or its proper functioning.

Section 10(c) provides the Commission shall not approve any acquisition (1) which the Commission finds is detrimental to the carrying out of the provision of Section 11, or (2) unless the Commission finds it will serve the public interest by tending towards the economical and efficient development of an integrated public utility system.

Thus, sections 9 and 10 act as measures to prevent the recreation of the situations which are eliminated by the enforcement of Section 11.

Section 12 deals with intercompany loans; indemnification of, or lending of credit, by one company to another; the payment of improper dividends, the sale of outstanding securities and utility assets, proxies, intrasystem transactions. In particular, Section 12(h) makes it unlawful for any registered holding company or subsidiary to make political contributions.

Section 13 deals with service, sales and construction contracts. Section 13(a) prohibits a registered holding company to perform such services for any other company in its system. Section 13(b) prohibits any mutual service company or subsidiary service company in a holding company system to perform such services except in accordance with such terms as the Commission shall prescribe to assure that such services are performed at cost fairly allocated among such companies.

Section 14 deals with reports to the Commission. Section 15 deals with accounts and records. Section 16 makes it unlawful to file a false or misleading statement with the Commission.

Section 17(a) deals with reports to the Commission by officers and directors of companies in registered holding company systems. Section 17(b) is the counterpart of Section 16(b) of the Securities Exchange Act of 1934. In particular, Section 17(c) prohibits any representative of any bank, trust company, investment banker or banking association from being an officer or director of any registered holding company or subsidiary thereof. This is a prophylactic provision to prohibit the determination of the financial activities of companies in registered holding companies to be made by persons personally interested in obtaining contracts for such activities. Holding company systems and utility companies generally issue and sell securities probably more often than other industries. This section assures that decisions as to what and when securities are to be sold will be determined by persons having allegiance solely to the need of the companies.

The remainder of the Act deals with administrative and court matters.

It can thus be seen that the Act is regulatory in nature. It prohibits certain kinds of transactions and requires Commission approval of a variety of activities. The Commission is required to make financial and economic decisions. This is unlike the Securities Act of 1933 which relates solely to disclosure in the sale of securities to the public; and unlike the Securities Exchange Act of 1934, which deals with reports required to be filed with the Commission, prohibits manipulation and fraud in the sale of securities, the full and fair presentation of financial statements by publicly held companies, information required to be disclosed in take-over efforts, disclosure of facts in proxy statements, and, of course, oversight of self regulatory associations, the trading markets, clearing agencies and transfer agents.

Under this Act, the Commission is not involved in the setting of rates. At the local level, the State public utility commissions set the rates; and the rates for the electricity carried from one state to another, and the rates for the transportation of natural gas across State lines, are determined by the Federal Energy Regulatory Commission.

As indicated, the State regulatory commissions have no jurisdiction over the activities of a holding company. This is particularly true where the holding company is incorporated in a State in which none of its subsidiary public utilities operate—there is no way, for instance, for the State in which the subsidiary utility operates to obtain the books and records of the holding company.

Similarly, as to service companies. If the service company is incorporated in a State in which none of the public utility companies operate, there is no way whereby those State commissions can examine the books and records of the service company. And, if the service company is organized by individuals, say the president and other officers of the holding company, makes no public offering of its securities, its financial statements would not have to be filed with the SEC under either the Securities Act or the Securities Exchange Act.

As is apparent, this Act is a conservative act. It requires a registered holding company to be in only one business—either that of electric utility operations or retail gas operations and businesses reasonably incidental to the operations of such system, and to additional systems which satisfy certain conditions. The one business must consist of companies the operation of which constitute an "integrated public-utility system" located in a single area or region.

The capital structure of a holding company system must be simple. There can be no more than three tiers of companies in the system, the system's capital structure cannot be complicated and the holding company is normally required to hold all the voting securities of each of its public utility subsidiaries.

Normally, the capital structure of each company in the system can consist of only first mortgage bonds and voting common stock—a simple capital structure.

Incidentally, this Act makes it difficult for any person to take-over a registered or exempt holding company system. Before the take-over offer can be made, an application must first be filed with the Commission and its approval for the acquisition be obtained.

In conclusion, I believe the Public Utility Holding Company Act has served and continues to serve as an important bastion in the protection of investors and consumers. It must be remembered that the electric and gas utility industry is possibly the basic industry of the country—without it, hardly any, if any, other industry could operate.

Senator D'AMATO. Mr. Freedman, I want to thank you again for your review of the Holding Company Act, its genesis, what it is intended to do, and for your comments with respect to the proposed bill. When I return we will ask the panel consisting of Stanley York, Chairman, National Association of Regulatory Utility Commissioners and Richard Schuler, Commissioner, New York Public Service Commission, Albany, N.Y., to testify. I will ask them to summarize their testimony, so we can attempt to move the hearing along.

Thank you, Mr. Freedman. We will take a 7 or 8 minute recess.

[Short recess.]

Senator D'AMATO. The subcommittee will come to order. Mr. York and Mr. Schuler, as a result of the fact that I will have to leave again to vote, I ask you to to summarize your statements. Of course the record will present (and we will take) your statements as if read in their entirety.

And also if you would attempt to concentrate on the proposed amendment to S. 1174, I would appreciate it.

STATEMENT OF STANLEY YORK, CHAIRMAN, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, COMMITTEE ON ADMINISTRATION, WASHINGTON, D.C.

Mr. YORK. I appreciate the opportunity to be here. I am Stanley York, Chairman of the National Association of Regulatory Utility Commissioners' Committee on Administration, and have chaired the NARUC Ad Hoc Committee on Utility Diversification and am now chairing the Ad Hoc Committee for the Study of the Public Utility Holding Company Act.

I am pleased to be here representing NARUC and to comment on the bill before you.

I would add, as a footnote, that my testimony is a living illustration that legislation is a continuing process, and that most of what I have to say is to give you a status report on that continuing process and to identify the issues that still remain and where they are in relation to resolution.

You have my printed remarks, and I will not be repeating any of the material that is there. Those printed remarks do represent the consensus of our committee which represents both those who want to see the act repealed and those who don't want any change in the act at all.

The situation is further complicated by the fact that we have some broad general agreement and some disagreements with the utility representatives on some of the mechanics of how to accomplish those broad areas of general agreement.

Commissioner Schuler from New York in a few minutes will give you more detailed comments. I am speaking on behalf of the committee and will deal more with the broad principles, but we are both singing from the same hymnal as we deal with the issues that are before you.

Let me say parenthetically that our concern is adequate service at reasonable rates. We recognize we have to have viable utilities, and utilities whose capital structures are not impaired, whose resources are not drained. The problem for us is how you reach beyond the State boundaries to track a problem you find in the course of regulating a utility and the issue is how to allow for reasonable business evolution without putting a burden on ratepayers, an unreasonable risk, and provide for reasonable supervision of that evolution without excessive regulation.

Last year when this type of legislation was introduced, State regulators were very much afraid that the absence of the act would create the opportunity for serious undermining of the financial viability of monopoly utilities. When Congress did not pass a bill, we entered into extensive discussions with the proponents of those proposals and those discussions have been very fruitful. We have identified the issues and narrowed them, the discussion continues, and we are reaching culmination.

We have accepted the principle of diversification and the utilities have accepted the need for oversight.

"NO-HARM" ZONE

The most creative notion in the proposal is the "no-harm" zone. We are concerned about the impact of the diversification, but the utilities argue, how can they prove that our fears are unfounded if we don't allow them to create a track record. Hence the "no-harm" zone, an area of freedom large enough to allow the utilities to show us they can do it without harm to the ratepayers and small enough to prevent serious damage.

There are serious issues remaining. They are important, but I believe they are resolvable.

First, in regard to exemptions. We can not accept the proposal that exemptions should be unconditioned or automatic. Who carries the burden and the standard of proof are still in contention. The basis of thresholds still are not settled.

Second, the burdens and thresholds are not settled in regard to registered companies, though we are close on both.

Third, access to books and records is of serious concern. We know well the difficulties of auditing utilities with our limited staffs. When we find an issue of potential cross-subsidy we must see the other side of the coin by looking at the affiliates in regard to that issue.

The use of a Federal remedy in the bill is a step forward, but it needs an administartive alternative as well. My testimony proposes a resolution to the books and records issue that may well be a cure worse than the disease, and I will file with this committee an alternative mechanism I think will be more acceptable to all.

Again, on this issue I think we are close to resolution.

The principle of simultaneous notice is important and will speed up the process for all parties involved. Extended to all aspects of the bill, we should be able to alleviate our concerns about our ability to function effectively in this regard.

Commissioner Schuler's testimony discusses effective dates and sunset dates which I think will strengthen the bill as well.

In summary, we are nearing the end of a fruitful process, and after we have had an opportunity to review the results of these hearings, we would hope to be able to meet with the utilities to propose further suggested amendments for your consideration. What we will try to do is to deal with the mechanics in a proposal and let the Congress focus on what it is the bill seeks to do, and the major purposes seeks to accomplish. I think we are not far from reaching that kind of agreement, which we will then be in a position to present to you for your consideration.

Mr. Chairman, I would be happy to respond to any questions you may have after Commissioner Schuler's presentation.

Senator D'AMATO. Thank you very much. Commissioner Schuler.

STATEMENT OF RICHARD E. SCHULER, COMMISSIONER, NEW YORK PUBLIC SERVICE COMMISSION, ALBANY, N.Y., ACCOMPANIED BY SAM LANIADO, STAFF COUNSEL

Mr. SCHULER. Thank you, Mr. Chairman. I would like to introduce our staff attorney with the New York Public Service Commission, Mr. Sam Laniado, who is here to assist me.

I, too, am very happy to have the opportunity to be invited back this year again to comment on the proposed amendments to the Public Utility Holding Company Act.

First, there is some progress in these proposals, particularly on a philosophical level. I still have a great deal of difficulty with the details, and unfortunately this is one of those kinds of bills that takes all 24 of your fingers to read as you flip back and forth. Every time I go through it, I find another detail that raises a question.

I don't plan to go into those details today. Some of it is contained in my prefiled testimony. I would hope we would have an opportunity to file more elaborate comments on those individual details.

Senator D'AMATO. Commissioner, as a result of the time constraints, we will submit to you some questions in writing, so that the record will reflect your concerns.

SOME DIVERSIFIED INVESTMENTS WITHOUT SCRUTINY

Let me ask you this: On page 7 of your testimony you indicate that some no-harm level of diversified investment should be permitted without scrutiny. Would you elaborate on that?

Mr. SCHULER. Those are the threshold levels that in fact are proposed in your amendments. I would quibble with the level of that threshold but not the principle. A rough guideline might be 5 percent of the net book value of the utility.

Senator D'AMATO. So we use 10 percent——

Mr. SCHULER [continuing]. Of the capitalization which is on the other side of the balance sheet. I think 5 percent is a more realistic number looking at it from the potential to harm utility customers. If that 5 percent investment were all to go down the drain, what impact would it have on the holding company's ability to continue to provide reasonable utility service?

Senator D'AMATO. So you feel safer with 5 percent because if utilities make an unwise investment, the resulting problems would not impair the effectiveness of the utility or the capital structure of the utility?

Mr. SCHULER. That's right, as a threshold level. As a footnote, there may be an even better accounting mechanism for forming the base of the threshold investment level. Consider the common equity of the operating utility, and then apply a higher threshold percentage, say 10 percent, because it is being applied to a smaller amount. Either formula leads to roughly the same dollar amount that a utility could invest before coming under the act. After all, with American Electric Power, that 5 percent of net utility plant or 10 percent of equity amounts to roughly $500 million. That is a substantial diversified investment that is permitted before SEC oversight begins. It is virtually half of what GM spent to build the X body automobile assembly line, and that is about the biggest single private unregulated investment made by any company in the United States in recent years.

DELAY IN AMENDMENT TO THE ACT

Senator D'AMATO. You have suggested a delay in the effectiveness of any amendment to the act in order to allow the States to take whatever legislative and regulatory measures as are appropriate.

Would it, in your opinion, or both of your opinions, be necessary to delay all of the amendments, or just certain ones, and if you feel just certain ones, would you then at some point comment to us in writing which ones you think should be delayed?

Mr. YORK. I think there are several things that the States will have to look at. If they do not have affiliated interest statutes, they will have to look at enactment of those in order to implement what is picked up in the act.

I think we can probably identify some areas where effective date is not important. There are others where it would be critically important and we would be happy to respond in writing to that question.

Senator D'AMATO. I have several other questions, but again a vote is taking place. I apologize, that I have to leave. I will ask the staff to give you some of those questions that we have prepared for today so the record can be complete with your remarks and also be published as soon as possible.

[Questions and answers can be found on p. 92.]

Gentlemen, the cooperation of you and your association has been outstanding, and it has helped us to narrow some of the gaps. We will look very closely at some of the suggestions with respect to threshold, et cetera, that you have proposed today. I think it is certainly something we should consider. Ten percent might be too much to start off with therefore maybe we should move that figure down.

Mr. SCHULER. If I might quickly call your attention, Senator, to a proposal I made in my prefiled testimony for a reporting requirement over the first 5 years that any amendments are in force. That would give us some sense of how the utilities are faring, and whether there are any untoward abuses taking place. If that automatic review were built into the amendments, I think it would go a long way toward relieving the anxiety about launching something new and unfamiliar. The review would allow everyone to have a subsequent opportunity to comment and expose any abuses if they did in fact occur.

Mr. YORK. And would give Congress the same sense of what is going on, so you would have a current sense of the implementation of the act.

Senator D'AMATO. Thank you very much. We will take another brief recess.

[Short recess.]

[The prepared statements of Mr. York and Mr. Schuler follow:]

STATEMENT OF THE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Good morning, Mr. Chairman and Members of the Subcommittee:

My name is Stanley York. I am a Commissioner of the Public Service Commission of Wisconsin, a position I have held since 1979. I am testifying today on behalf of the National Association of Regulatory Utility Commissioners, commonly referred to as the NARUC. Accompanying me today are Paul Rodgers, NARUC Administrative Director and General Counsel; Rita A. Barmann, NARUC Director of Congressional Relations; and Linda Kent, NARUC Assistant Director of Congressional Relations.

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of government regulation in America.

The members of the NARUC appreciate this opportunity to make known our views on S. 1174, a comprehensive package of proposed amendments to the Public Utility Holding Company Act of 1935 (PUHCA)[1/]. As you know, State regulators were among the strongest opponents of legislation introduced in the 97th Congress which would have substantially modified or completely repealed the Act. Our opposition was based upon our firm belief that Federal oversight as provided under the Act is an important tool that assists the States in the effective regulation of investor-owned electric and natural gas utility companies.

Underlying our analysis of last year's legislative proposals regarding PUHCA as well as the current S. 1174 are two uncontro-

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[1/] 15 U.S.C. § 79 *et seq*.

verted facts. First, electric and gas utilities are natural monopolies which in the absence of regulatory oversight would have a strong incentive to unfairly exploit their customers through their monopoly power. Secondly, without some degree of Federal regulation, diversified interstate utility holding companies could in many instances preclude effective State utility regulation.

Although many of the specific abuses which led to PUHCA's enactment in 1935 are no longer with us (perhaps largely because of the Act's continuing effectiveness), these basic factual circumstances I have just spelled out have not been--and will not be--altered over time. In recognition of these realities, therefore, the NARUC Executive Committee (of which I am a member) adopted a resolution in July 1982 opposing repeal of the Act and supporting amendments only to the extent that they maintain a "core" of Federal oversight responsibilities with respect to holding companies currently affected by PUHCA. To assist in applying these principles to proposed PUHCA amendments introduced in the 98th Congress, three months ago the Executive Committee established an Ad Hoc Committee on Public Utility Holding Company Act Issues. This committee, composed of seven State commissioners and chaired by myself, has carefully considered the revisions to the Act proposed in S. 1174. My testimony today reflects our collective viewpoint regarding the degree to which this bill would preserve the Federal role advocated by the NARUC and thereby protect the interests of monopoly utility ratepayers.

I would like to note that my fellow panelist, Commissioner Richard E. Schuler of the New York Public Service Commission, is also a member of the NARUC Ad Hoc Committee on Public Utility Holding Company Act Issues. Although the entire committee has not yet had a chance to review Commissioner Schuler's prepared statement submitted for this morning's hearing, we do concur with the substance of his comments as they relate to issues not specifically addressed in my testimony on behalf of the NARUC.

The NARUC Position on S. 1174

At the outset, I would like to commend you, Mr. Chairman, for offering PUHCA legislation which goes a long way toward addressing the State regulatory concerns voiced during last year's deliberations on the matter. S. 1174 is clearly an improvement over the proposals considered during 1982. Nonetheless, the NARUC cannot support the bill without further modification of its provisions relating to: exemptions from the Holding Company Act's scope, including the allocation and weight of the burden of proof; State commission access to holding company books and records; the threshold for application of the Act's regulatory requirements with respect to holding company financing and diversification activities; and the scope of the notice requirement to State commissions with jurisdiction over a utility subsidiary of a holding company. In the remainder of my testimony, I will elaborate on our concerns in these respects and suggest appropriate corrective amendments to S. 1174.

A. Exemptions from PUHCA Registration Requirements

Under the Act as currently written, the Securities and Exchange Commission (SEC) is responsible for administering a comprehensive regulatory oversight program for electric and gas utility holding companies which is founded upon compulsory registration of all such holding companies that do not qualify for an exemption under Section 3 of the Act[2] (or under the Commission's rules and regulations pursuant thereto). Section 4 of S. 1174 would both broaden the Act's exemptive provisions and narrow the SEC's authority to grant, deny or revoke these exemptions. The NARUC's concerns in this regard revolve around the latter proposed revisions.

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[2] 15 U.S.C. § 79c.

Under Section 4 of the bill, the SEC would be required to grant an unconditional exemption from the Act's registration requirements unless it determines, by means of "specific factual findings made upon clear and convincing evidence," that the exemption materially adversely affects the public utility business of the requesting holding company. A State commission with jurisdiction over the affected utility would be expressly provided with the right to request an SEC investigation concerning the exemption request.

Although we appreciate that the bill's authors seek to add certainty to the PUHCA exemption process, the NARUC does not believe that eliminating the SEC's authority to impose conditions on exemptions is an appropriate means of effectuating this goal. We see no reason why the SEC's administrative discretion should be reduced such that it may not identify specific terms under which an individual exemption is granted. Moreover, the granting of a conditional exemption speeds the administrative process in that it narrows the issues to be considered in a revocation proceeding should the exemption be challenged later on the basis that the condition has not been met.

We therefore suggest that the bill be amended to include a provision which would expressly allow the SEC to make the granting of exemptions conditional upon terms determined by the Commission as necessary to protect the public interest. [3]

We also object to the manner in which the burden of proof would be allocated under the exemption application process envisioned in S. 1174. In our view, the importance of ensuring that the regulatory protections provided under the Act are applicable wherever they are needed more than justifies putting the burden of proof on the entity which is seeking exempt status. We suggest, however, that the party seeking the exemption be required to meet a lesser evidentiary standard--i.e., "a preponderance of the evidence"--than that proposed in Section 4 of the bill.[4]

In order to avoid unduly burdensome delays in the exemption application process, we also suggest that a ninety-day time limit on final SEC actions be established, along with a "due diligence" standard so as to prevent deliberate delays on the applicant's part. 5/

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[3] This amendment may be made by:
(1) deleting Section 4(1)(A) of S. 1174, page 4, and renumbering subsequent subsections accordingly; and
(2) adding a new subsection (f) to the amendatory language contained in Section 4(2), pages 5-6, to read as follows:
"(f) The Commission may, by order or by rules and regulations upon its own motion, grant conditional exemptions under subsection (a) of this section if it finds such conditions to be necessary to protect the public interest.".

[4] This amendment may be made by revising Section 4(1)(C) of S. 1174, pages 4-5, to read as follows:
(C) by striking from ", unless" through "consumers" in the first section of such subsection and inserting in lieu thereof: "except section 3A and paragraph 2 of subsection (a) of section 9, if the Commission finds, after consultation with the State commission with jurisdiction over the public-utility company of such holding company system, that the holding-company system requesting such exemption has shown by a preponderance of the evidence that the exemption will not materially adversely affect the public-utility business of such holding-company system, and".

B. State Commission Monitoring and Access to Books and Records.

One of the most important concerns identified by NARUC witnesses who testified at last year's legislative hearings regarding proposed PUHCA amendments was the need to obtain accurate financial and other information from utility holding companies. Without such data, State commissions cannot adequately ensure that the utility's ratepayers are not harmed by transactions between the utility and other affiliates of the holding company system. Likewise, decisions by individual States regarding a utility's diversification activities will have implications for the capital structure to be used for rate-setting purposes. Access to the appropriate books of the holding company is necessary in order to determine how to impute the correct capital structure.

Some, but not all State commissions have authority to impose reporting and accounting requirements on a utility's transactions with affiliates.6/ However, for both legal and practical reasons, even those States that have such authority may well have difficulty obtaining needed information from a holding company located outside their respective boundaries and conducting interstate operations.

5/ This amendment may be made by adding a new subsection (g) to the amendatory language contained in Section 4(2)(B) of S. 1174, to read as follows:

> "(g) The Commission shall grant or deny exemptions requested under subsection (a) not more than ninety days after an application requesting such exemption is filed: Provided, however, that the applicant exercise due diligence in meeting all substantive and procedural requirements of subsection (a) and as ordered by the Commission.".

6/ See Appendix.

We are thus pleased that S. 1174 includes a section that would give State commissions a new, Federally enforceable right to obtain the books and records of any associate company within a registered or exempt holding company system. The contemplated enforcement mechanism for this right is decidedly problematic, however: the State commission must file suit in Federal district court to obtain requested data not supplied by the holding company or its affiliates. Although the jurisdictional grant to Federal courts in this regard is coupled with an admonition that actions enforcing the State agency's access right be decided within sixty days "to the greatest extent practicable," the court would still retain ultimate authority to dispose of the matter when it sees fit to do so.

One of the underlying themes of S. 1174 is that greater deference to State regulatory oversight of utilities contained within holding company systems is both feasible and desirable under an amended Holding Company Act. State regulators can live up to these heightened expectations only if they have unimpeded access to all relevant information regarding the impact of holding companies upon utility subsidiaries within their respective jurisdictions. Indeed, this is the first stated purpose of these proposed amendments to the Act.

Given the fact that other provisions of S. 1174 would both enlarge the number of holding companies and specific company activities not otherwise subject to SEC regulation under PUHCA, it is essential that a regularized reporting mechanism be established to facilitate regulatory scrutiny of holding companies' diversified businesses. Accordingly, we propose that the bill be revised so as to place an affirmative books-and-records reporting requirement on all registered and exempt companies affected by PUHCA's provisions. After consultation with the State commissions, the SEC should develop regulations mandating the regularized filing of information by holding companies regarding the full panoply of their nonutility business activities, particularly their transactions with their utility subsidiaries. 7/

C. Threshold For Registered Company Financing and Diversification Activities Subject to PUHCA

I would like to turn now to a discussion of our concerns regarding S. 1174 as it affects regulatory restrictions placed upon registered holding companies under PUHCA. Sections 7 and 8 of the bill propose revisions to the Act's regulatory scheme applicable to such companies' issuances of securities and to investment in diversified businesses.

With respect to securities issues, Section 7 would narrow SEC review in two respects. First, instead of requiring prior SEC approval of each security issued, it would establish rather substantial exemptions from SEC review for certain types of financing. For our purposes, the most important of these exemptions would

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7/ This amendment may be made as follows:

(1) by deleting new Section 3A(a),(b),(c) and (d)(1) (contained in Section 5 of S. 1174);

(2) inserting in lieu thereof the following:
"Sec. 3A. (a). The Commission shall, by such rules or regulations as it determines to be required in the public interest, provide for the filing with the Commission of uniform reports concerning the nonutility business activities of holding-company systems. Such rules or regulations shall provide for the filing of such reports on a periodic basis. In determining the nature, level of detail, and frequency of such uniform reports, the Commission shall give due consideration to the need to avoid unnecessary duplication in reporting of information otherwise contained in public filings under the securities laws or otherwise and the need to safeguard against unwarranted public disclosure of any confidential business information."; and

(3) redesignating Section 3A(d)(2) as 3A(b).

apply to a holding company's guaranty of, or assumption of liability on, a subsidiary's security when the aggregate outstanding value of all such guarantees and assumptions of liability by the holding company is ten percent or less of the value of the holding company's total capital, capital surplus, retained earnings, and outstanding securities.

Secondly, it would modify the SEC's authority over non-exempt securities issues by requiring regulatory action on the issue request within 20 days after submission to the SEC. It would also permit registered holding companies to seek advance SEC approval of a two-year financing plan.

The changes proposed by S. 1174 with respect to diversification ventures contain a similar threshold mechanism whereby registered holding companies would be permitted to take action free of regulatory restrictions under PUHCA. The proposed amendments would permit registered systems, in addition to any investment already approved by the SEC, to make additional nonutility investment without SEC approval of up to ten percent of the holding company system's consolidated assets. Further diversification after this threshold is reached would be subject to specific SEC approval, unless it conforms with a diversification plan which also must pass SEC muster.

The NARUC does not object to the basic principle embodied in the threshold standard for application of PUHCA's financing and diversification restrictions: that it is not necessary to require exhaustive review and prior SEC approval of each and every holding company security issue or nonutility investment. Furthermore, we agree that periodic regulatory review of holding companies' diversification activities, while inadequate alone, should be an important facet of a streamlined administrative process to enforce relevant provisions of the Act.

Nonetheless, we are concerned that under S. 1174 as currently drafted, far too many potentially significant holding company financing and diversification activities would be beyond the SEC's purview. Although the ten percent threshold standard may appear to be a relatively inclusive one, it is pegged to the holding company's total capitalization (in the case of securities issues) and to its total consolidated assets (in the case of diversification). An example of this reference point: as of December 31, 1982, Central and South West Corporation -- the sixth largest of the 12 current registered holding companies -- reported total assets of over $5.1 billion.[9/] Under S. 1174, C & SW would be free to invest up to $500 million in any nonutility business of its choice with no regulatory scrutiny whatsoever as to the potential impact of the investment on its electric utility subsidiaries in five different States.

We are convinced that the goal of reducing "unnecessary" regulation, which S. 1174's provisions relating to holding company financing and diversification are meant to achieve, has been misapplied here. The only proper criterion for establishing a threshold below which holding company financing and diversification may proceed without regulatory scrutiny is the likelihood that the utility's ratepayers will be placed at risk by the business activity in question. The NARUC submits that a much lower threshold standard is necessary to ensure that ratepayer interests are adequately protected. We therefore request that the standard be revised so that a registered holding company's guaranty of a sub-

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[9/] Information supplied by the SEC's Division of Corporate Regulation.

sidiary's stock issue, or its investment in nonutility businesses, would be subject to SEC review when the total value of the stock issue or the investment is more than five percent of the holding company's net investment in its utility subsidiary's rate base assets, as determined by the State commission with jurisdiction over the affected utility. 10/ Alternatively, the threshold could be set at ten percent of the value of the utility subsidiary's outstanding common stock.

As a final matter, the NARUC has serious concerns that the various exemptions for securities issues could be employed individually such that the aggregate value of a registered holding company's financing which is not subject to SEC review is very substantial. We therefore suggest that consideration be given to establishing a cumulative ceiling on the total value of unregulated securities issues, beyond which the holding company would not be permitted to claim any of the securities review exemptions enumerated in the Holding Company Act or otherwise available under SEC rules or orders.

10/ These amendments may be made as follows:

(1) by revising the amendatory language contained in section 7, page 12, lines 13-23, to read as follows:

> "(D) the guaranty of, or assumption of liability on, a security of a subsidiary company by its registered holding company, if the aggregate of the principal amount and par value of the securities then outstanding of all subsidiary companies which are the subject of all such guaranties and assumptions of liability by such registered holding company is not more than 5 per centum of the aggregate assets of such registered holding company which are included in the rate base of such company's utility subsidiary or subsidiaries, as last determined by the State commission having jurisdiction over the utility subsidiary or subsidiaries."; and

(2) by deleting the amendatory language contained in Section 8, page 20, lines 13-25, and page 21, lines 1-8, and inserting in lieu thereof the following:

> "5 per centum or more of the aggregate assets of such holding company which are included in the rate base of such company's utility subsidiary or subsidiaries, as last determined by the State commission having jurisdiction over the utility subsidiary or subsidiaries.".

D. Notice to State Commissions

Section 14 of S. 1174, governing notice to the State commissions of SEC filings by holding companies under the Holding Company Act, is of considerable significance to the NARUC. Clearly, State regulators must be notified in a timely fashion of utility holding company requests and representations before the SEC if they are to be effective participants in the PUHCA regulatory framework. For this reason, we heartily support this section's mandate that the appropriate State commission must receive contemporaneous notice when a holding company files a request for an exemption from the Act's scope, a declaration requesting approval of a general plan for securities issues, or applications for approval of a diversification plan or specific nonutility business acquisition.

Regarding securities issues, however, we would suggest that there is no reason to limit notice to State commissions to instances where the holding company chooses to submit a general plan requesting advance approval of one or more issues during a 2-year period. We request that a similar notice requirement be made applicable *whenever* a registered holding company files a declaration regarding a securities issues under new Section 7(a) of the Act.

In addition, we believe it is necessary to provide the State commissions with notice of registered holding company activities which would fall below the threshold limit proposed elsewhere in S. 1174. Such a notice requirement would represent a relatively minor regulatory burden which is more than offset by the absence of any SEC scrutiny of the activities involved. Giving notice to the States of registered company actions which may have some impact on its utility operations but which do not rise to the threshold set for SEC oversight is an appropriate middle ground that fills the

State's need for complete factual data regarding the holding company's financing and business ventures. 9/

E. Additional Concerns

Even assuming that S. 1174 is revised in accordance with the views I have just detailed, enactment of this legislation will mark the beginning of a major transition in the nature and scope of Federal regulatory oversight of interstate utility holding companies. Given the undeniable uncertainties which surround our consideration of the amendments' likely impacts on utility ratepayers, we recommend that two precautionary changes to the bill be adopted. First, there should be a one-year delay in the effective date of any proposed changes to PUHCA, so that the States will have an opportunity to enact laws providing for any additional regulatory powers seen as necessary under an amended Federal statutory scheme.

9/ These amendments may be made by revising the amendatory language contained in Section 14 of S. 1174, page 36, lines 5-17, to read as follows:

> "Sec. 34. Any holding company that files an application for exemption under section 3(a) and any registered holding company that files a declaration pursuant to section 7(a) or section 7(b)(3), an application for approval of a diversification plan under section 10(g), an application for approval of the acquisition of an interest in any business under section 10(h), or that issues a security to which the provisions of section 6(a) do not apply, or that acquires an interest in any business other than the public-utility business which is not defined as a significant interest under section 9(d)(1), shall give contemporaneous notice of such application, declaration, issuance or acquisition at the time the filing is submitted to the Commission (or at the time the securities issue or acquisition becomes legally effective), in such form as the Commission may prescribe, to each State commission having jurisdiction to regulate a public-utility company in the holding-company system of such holding-company or such registered holding company.".

Secondly, the SEC should be directed to report to Congress periodically concerning the impact of any Holding Company Act revisions enacted at this time. 12/

Conclusion

Mr. Chairman, allow me to reiterate the NARUC's appreciation of your obvious efforts to accommodate the State regulatory community's concerns about effective regulation of interstate utility holding companies in the absence of the current Federal law. The debate concerning the continued usefulness of the Public Utility Holding Company Act has clearly progressed during the last year. We are no longer faced with a simple recitation of the small number of companies currently subject to the Act's requirements as a justification for repeal. As I observed at last year's hearings in the House on this matter, the absence of traffic accidents at a particular intersection is by no means a sufficient rationale for removing the stop sign altogether.

S. 1174 is an important step in our mutual efforts to find an appropriate balance of regulatory oversight and managerial flexi-

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12/ These amendments may be made by adding new Sections 15 and 16 at the end of S. 1174, page 36, to read as follows:

"EFFECTIVE DATE OF ACT

"Sec. 15. The amendments contained in this Act shall become effective twelve months after the date on which the Act is enacted.

"REPORT TO CONGRESS

"Sec. 16. The Commission shall conduct periodic studies to the impact of the amendments made by this Act upon the effective regulation of public-utility holding-company systems and shall report its findings thereon to Congress. The first such report shall be submitted not later than twenty-four months after the date of the Act's enactment. In conducting such study, the Commission shall pay particular attention to the effect of said amendments on the ability of the State commissions to protect the interests of the ratepayers of utilities which are contained within holding-company systems.".

ability for the holding companies impacted by PUHCA. As my testimony today makes clear, we are not satisfied that a reasonable balance in this regard has been reached in the bill before you. I and the other members of our Association stand ready to assist you as you and your colleagues in Congress undertake to amend the Act in a manner which is consistent with the public interest.

Thank you for your consideration of our concerns.

Source: National Association of Regulatory Utility Comm'ers, 1981 Annual Report on Utility and Carrier Regulation

APPENDIX

TABLE 78 - TRANSACTIONS WITH AFFILIATES

AGENCY	The Agency prescribes special requirements for transactions with affiliates -	
	Accounting	Reporting
FCC and FERC	Prescribed system of accounts and annual report forms, require maintenance and reporting of separate accounts for investments in advances to, notes receivable from, accounts receivable from, advances from, notes payable to, and accounts payable to affiliates.	Same.
ALABAMA PSC	Yes.	Investigation by staff.
ALASKA PUC	Yes.	Yes.
ALBERTA PUB	No special requirements established to date.	No special requirements established to date.
ARKANSAS PSC	Per system of accounts and annual reports; also same requirements as FERC and FCC, where applicable.	Same.
CALIFORNIA PUC	Accounting requirements same as FERC and FCC.	Same.
COLORADO PUC		Reasonableness of affiliate transactions are considered in rate cases.
CONNECTICUT DPUC		Service contract charges from affiliates are reported in the utilities' annual reports.
DELAWARE PSC	Accounting requirements same as FERC and FCC.	Reporting requirements same as FERC and FCC.
D.C. PSC	Any special accounting treatment it requires.	The Commission can set those reporting requirements necessary to carry out its statutory responsibilities.
FLORIDA PSC	Yes.	Yes.
HAWAII PUC	Yes.	Must submit consolidating statements with explanation of transactions and basis of allocation of common expenses.
IDAHO PUC	Reviewed in rate cases.	This commission does not have an affiliated interest statute.
ILLINOIS CC	Approval of all transactions except those specifically excluded by Sec. 8(a) of the Public Utilities Act.	File reports relative to such transactions as the commission may prescribe.
INDIANA PSC	Yes.	Yes.
IOWA SCC	Records of transactions must be preserved in the same manner as for the utility. Extraordinary documentation may be required and pricing is subject to greater scrutiny.	Same as FERC and FCC.
KANSAS SCC	Making adjustments for cases of ratemaking (Statute requires full disclosure).	Must identify related companies in annual report, file all contracts and keep Commission fully informed of transactions (required by statute).
LOUISIANA PSC	Yes, insofar as certain transactions are concerned.	
MAINE PUC	Only as occasion requires.	Only as occasion requires.
MARYLAND PSC	No special requirements prescribed would follow requirements of the uniform system of accounts and report forms.	
MASSACHUSETTS DPU	To the extent that they affect the regulated utility adversely.	Requires an abbreviated report form from each affiliate.
MICHIGAN PSC	Per system of accounts.	Yes, in rate case filing requirements and annual reports.
MINNESOTA PUC	Per system of accounts.	Part of Annual Report.
MISSISSIPPI PSC	No.	No.
MISSOURI PSC	Yes.	Yes.
MONTANA PSC	Must be absolutely separate.	All transactions are kept separately.
NEBRASKA PSC	All transactions deemed necessary by PSC.	Same.
NEVADA PSC	Depends upon specific transactions.	
NEW HAMPSHIRE PUC	Depends upon specific transactions.	Must submit various contracts which affect New Hampshire utilities - such as contract for services rendered and charged to utility.
NEW JERSEY BPU	Transaction must be reasonable and provide for elimination of unsupportable gains.	Description required to be given in annual report plus supplemental reports if deemed necessary.
NEW MEXICO PSC	Limited authority under new legislation to investigate certain subsidiary relationships.	
NEW YORK PSC	Companies required to keep accounts so as to be able to accurately and expeditiously produce statements of all transactions with associates.	Commission has authority under its general powers to require any special reports to keep the commission informed.
NORTH CAROLINA UC	The type and dollar amount of the goods and services represented by transactions between the regulated company and its affiliates must be identifiable in the books of accounts of the regulated company.	Annually the regulated companies must report the type, dollar amount and the name of the affiliate from which goods and services were received.
NORTH DAKOTA PSC	No prescription found necessary to date.	No prescription.
NOVA SCOTIA PUB	No special requirements established to date.	No special requirements established to date.
OHIO PUC	Commission has authority but no standards have been adopted. Not significant in Ohio.	Part of annual report. Commission has authority to require report.
OKLAHOMA CC	As required by uniform system of accounts.	Same.
ONTARIO EB	No special requirements established to date.	
OREGON PUC	Furnish detail of costs and no profit between affiliates.	File detail of all transactions showing costs and other pertinent data.
PENNSYLVANIA PUC	Commission has authority to approve acquisition by a public utility of 5 percent or more of the voting capital stock of any corporation.	Requires Commission Order within 30 days.
QUEBEC REB	No.	No.
RHODE ISLAND PUC	Yes.	Yes.
SOUTH CAROLINA PSC	All necessary steps to protect consumers.	Reports and other transactions filed and reviewed by the commission.
SOUTH DAKOTA PUC	Yes.	Yes.
TENNESSEE PSC	Yes.	Yes.
TEXAS PUC	Yes.	PUC has power to require any special reports to keep it informed.
UTAH PSC	There are no specific provisions in our law on these items but the commission is of the opinion it has adequate authority under the section of the law relating to accounts and records to prescribe such requirements.	Same.
VIRGIN ISLANDS PSC		Part of the Annual Report.
VIRGINIA SCC	Yes.	Yes.
WASHINGTON UTC	Maintain record of the cost of the services provided by the affiliate and if ascertainable the cost of all items sold to the utility.	All services and things should be provided at cost by the affiliate and annual reports of the cost thereof are filed with the commission.
WEST VIRGINIA PSC	As required by uniform system of accounts.	As required by annual report.
WISCONSIN PSC	Highly extensive.	Yes.
WYOMING PSC	Generally, complete separation of operations with only benefits flowing to utility.	Requirements patterned to facts of each case.

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June 17, 1983

The Honorable Alfonse M. D'Amato
520 Hart Senate Office Building
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Washington, D.C. 20510

Re: S. 1174, A Bill Proposing the Public Utility Holding Company Act Amendments of 1983

Dear Senator D'Amato:

At the conclusion of the June 14 hearing, I was asked to respond to certain questions concerning the above-referenced legislation. This letter is in response to that request. I respectfully request that this letter be made part of the June 14 hearing record.

By way of introduction:

State regulators have two major concerns: to see that utility service costs no more than absolutely necessary and that those costs are distributed fairly among ratepayers. All utilities are engaged in nonutility activities of one kind or another and have been for many years. A predominate task of State regulation is and has been to see that costs paid for in rates are only for activities necessary for the provision of utility service. One of the motivating forces out of which State regulation was created was the necessity to prevent subsidization of nonutility activities by monopoly ratepayers. We spend a great deal of time, effort and money on this task and are confident that we have been largely successful.

State regulators regularly resolve questions of the allocation of joint and common costs in favor of the ratepayers against the stockholder. This may sometimes result in an impact on competition with nonutility competitors which could help or hurt the competitor. In many of these instances it is a choice between the ratepayer and the competitor, with the utility in the role of bystander.

For example, if a telephone utility has a trencher for laying underground cable that is used only 80% of the time, should the utility be allowed to sell the idle time (20%) to other utilities? From a ratepayer perspective, the answer is obviously affirmative as that revenue will reduce the amount of revenue required from ratepayers. How should the costs of the trencher be allocated? Obviously, the outside customer should pay the out-of-pocket cost of the service, but how much of the general overhead of the business should be allocated to this activity will depend on competitive prices and how non-utility competitors have allocated these costs.

Question 1:

Isn't cross subsidization best prevented by State regulation? What incentive is there for State regulators to permit cross subsidization of a non-utility business by a utility?

Answer:

The ratesetting agency is the only one that can prevent cross subsidization because it is the one deciding what constitutes subsidization, and sets rates that are or are not compensatory. There are no incentives for State regulators to permit cross subsidization. The only element standing in the way is a lack of staff, which would preclude adequate analysis of the utility.

Question 2:

I understand the Alliance's concerns to be related to the possibility of cross subsidization. Section 3A provides the State commissions with a new, federally guaranteed right to non-utility books and records. As a State commissioner, what incentive is there for you to increase utility rates so as to enable a utility to cross subsidize its non-utility business?

Answer:

There are no such incentives.

Question 3:

Last year NARUC testified in opposition to repeal or substantial amendment of the Holding Company Act. Doesn't this legislation specifically address many of the concerns you raised last year? Don't you think this legislation represents a rather substantial compromise on the part of the utility industry?

Answer:

S. 1174 specifically addresses many of the concerns raised by State regulators last year. Some still remain. We recognize that S. 1174 represents substantial compromise by both utilities and regulators, but the task is not quite complete.

Question 4:

On page 7 of your testimony, you indicate that some "no harm" level of diversified investment should be permitted without further scrutiny. Could you elaborate upon your comment? How do you measure the level of diversification? Would you restrict the nature of the diversified activities?

Answer:

The "no harm" zone is that area below a threshold set to keep ratepayers from harm while allowing utilities to show they can diversify. The level of diversification is determined as a percentage of some measure of assets available for this purpose. We are not proposing to restrict the nature of diversified activities.

Question 5:

How would you modify this bill to ensure that State regulatory authorities have meaningful and adequate participation when the SEC is called upon to make decisions concerning the financing or diversification activities of holding company systems?

Answer:

A provision for conditional exemptions and the extension of simultaneous State notification will give meaningful participation to State regulators.

Question 6:

Your suggestion for a delayed effectiveness of any amendments to the Holding Company Act in order to allow States to take whatever legislative and regulatory actions are appropriate. Would it be necessary to delay all the amendments?

Answer:

The reason for the requested delay is to give State legislatures a chance to review their statutes in light of the Federal changes. Because the amendments are an integrated package and cannot be split to be effective at different times, they all should be delayed.

I deeply appreciate this opportunity to provide the views of the State regulatory community on these issues. It is my hope that these responses prove useful to you and your colleagues as this legislation is deliberated. I stand ready to provide further assistance at your request.

Respectfully,

Stanley York

Stanley York
Chairman
Ad Hoc Committee on Public Utility
Holding Company Act Issues

SY:jrf

U.S. Senate Committee on Banking, Housing and
Urban Affairs, Subcommittee on Securities

Statement of Dr. Richard E. Schuler
Commissioner and Deputy Chairman,
New York State Public Service Commission
Three Empire State Plaza
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on

S.1174, A Bill Proposing Amendments to the
Public Utility Holding Company Act of 1935

June 14, 1983

It is a pleasure for two reasons to have the opportunity to come before you again this year to discuss proposed revisions to the Public Utility Holding Company Act of 1935 (PUHCA). First, although this proposed legislation contains many features that I believe would seriously compromise the ability of state regulators to perform their functions effectively, it nevertheless identifies several acceptable resolutions to disturbing issues that were inherent in last year's proposals. Second, as I predicted in my testimony last year, one of the strongest forces which at that time motivated the push for utility diversification has now largely disappeared, namely, the dire financial problems of the electric utility industry. (Given the recent abuse economists have taken for their predictive failures, I feel some professional compunction to bask in the limelight of one correct forecast). This circumstance is important since it removes the aura of crisis surrounding the discussion of utility diversification and permits us to examine this proposed legislation on a rational dispassionate basis. What we need to focus on is what Federal regulatory oversight is necessary over diversified, interstate utilities so that the interests of utility customers and investors are protected. The opposite way to examine that question, of course, is to explore how diversified interstate utilities can escape the normal regulatory functions of state governing bodies.

I. Overview of Testimony

I encourage you to review my testimony before this Committee a year ago, since the proposed general guidelines are still applicable today. In particular, utilities are by definition natural monopolies who possess the inherent power to gouge the public. The potential for abuse is amplified when these utilities are interstate in nature so they can effectively escape the grasp of any single state regulatory authority. The 1935 Act has worked well since we observe little of those past abuses today. However, this fact should have a bright yellow flag to proceed with caution, or else in our urge to tinker we may undo so successful a piece of legislation. On the bottom line, I simply don't want to be forced to raise utility rates in New York because of something happening in Montana. While this may sound far-fetched, I call your attention to the sorry litany of San Insull to understand the potential serious and convoluted consequences of any loosening of the strictures present in the existing Act.

Having preached these cautionary admonitions, let me begin my discussion of possible amendments to the Act by reviewing the minimum requirements which are necessary prerequisites for providing effective state regulation. Last year, I suggested three R's that must be accomplished through SEC regulation of diversified, interstate utility holding companies. They are:

1. Effective Access to and Production of Records and Information
2. Periodic Upfront Review of Investment Plans; and
3. The Reconciliation of Individual Financings with the Accepted Investment Plan.

Obviously, the legislation also requires some teeth, and the ultimate "club in the closet" is the authority to order divestiture if public harm can be shown.

The other principle that I urge you to continue to observe, which has been emphasized to me by serving on the NARUC Ad Hoc Committee on Utility Diversification last year and through this year's participation on the NARUC Ad Hoc Committee to study PUHCA, is that every state's interests and problems are somewhat different. Thus this legislation requires the flexibility to accommodate those differing perceptions and needs.

The original Act and these proposed amendments are extraordinarily complex, and I have many specific comments and suggestions, as well as questions about proposed changes whose implications I do not understand. However, I hope not to wear out my welcome by elaborating those details. Rather, I hope I could be afforded the opportunity at some future date to convey that detailed litany of specifics in writing. Today, however, I think it is more useful to summarize the general sweep of revisions that are necessary to allow interstate companies to diversify with a minimum of regulatory shackles, but that would still provide adequate protections for regulators, and in turn, utility customers.

Certainly, exemptions from the Act should be granted, if a proper showing can be made that no harm to utility ratepayers will result. Furthermore, registered companies should be allowed to diversify, provided a proper level of oversight is maintained. That oversight should be focused upfront through a periodic filing of a broad diversification investment plan. It is at that initial stage that a debate should take place and potential dangers to utility customers be enumerated. Once the diversification plan is accepted, there would be no need for case-by-case approval of individual utility investments, other than to be sure that the holding companies were functioning within the boundaries of their plans. Individual financings would continue to be filed with the Commission and should be speedily accepted unless the Commission or some state regulatory body showed those financings were inconsistent with the approved diversification plan. Other requirements include effective access to records of utility and non-utility subsidiaries of the holding companies by state regulatory bodies and some flexible guidelines dealing with transactions between non-utility and utility subsidiaries.

The single largest disparity between those guidelines and the specific language contained in the proposed amendments to the Act is the allocation and burden of proof for a number of actions. When analyzing this issue, I believe that the burden of proof should be allocated based upon a capacity to harm, regardless of good intentions. As an example, the responsibilities for the actions of the proverbial bull in the china shop must rest upon the bull's owner, no matter how docile, well-trained, or benevolent the intentions of that animal, since by one misstep, the potential havoc he can create is so enormous. So, too, the potential injury that can be inflicted by potential miscues of utility holding companies is so large, because they are natural monopolies, that the burdens of proof in most cases must rest squarely on their shoulders if the public interest is to be adequately protected.

II. Specific Comments on Proposed 1983 Amendments

It is ironic that of four purposes enumerated in Section 2(b) of the amendments, three provide benefits to utility holding companies; whereas, only one inures to their regulators and customers. To provide a balanced perspective, I propose adding the following fifth purpose: To ensure that state regulatory authorities have meaningful and adequate participation when the Commission is called upon to make decisions concerning the financing and/or diversification activities of holding company systems.

In granting exemptions under Section 3, I wholeheartedly agree with Commissioner York that those exemptions not be unconditional, that the SEC be permitted to attach specific conditions upon consideration of state comments, and that the burden of proof is too tough and on the wrong foot. In fact, my legal experts tell me that the proposed burden for Section 3(a) that requires that the SEC or state commissions provide "specific factual findings made upon clear and convincing evidence that the exemption materially adversely effects the public-utility business of such holding company system" is typically used to rebut presumptions involving the legitimacy of parenthood or the validity of a marriage. In short, it is a very tough standard that is normally applied in order to decide if something should be torn apart. I think that this standard is entirely proper where the Commission seeks to order the divestiture of a non-utility subsidiary under Section 11. But, in all other sections of these amendments, the purpose is to permit something to be assembled, and there the proper burden should be placed on the utility or holding company to show that the intended action will at the very least result in no harm to utility customers. In fact, I find it difficult to resist the urging of New York State's staff to recommend a far more stringent standard requiring the utilities to show some net positive benefit to society before a diversification is permitted).

Furthermore, it is not clear to me, from a public policy perspective, why the "unless and except" clause should be removed from Section (3). Leaving it requires the SEC to make a determination of and specify conditions for permitting an exemption. Traditionally, the conditions have included the required reporting and disclosure of information that is necessary to monitor the holding company behavior and to insure that the public is not being harmed. It is only the shifting of the presumption of the right to diversify to the utility that requires the addition of Section 3A, which acknowledges the rights of state regulators to have access to information on both regulated and unregulated diversified subsidiaries. If the changes are to be adopted, the need for flexibility has become abundantly clear through my membership on the NARUC Ad Hoc Committees. My own staff in New York State is adamant in insisting this procedure be shifted from the Federal District Court to a more informal, administrative proceeding within the SEC. Their concern arises from a state legislative mandate to reach a decision on specific cases within eleven months. It is possible that by the time the disputed records are obtained through the Federal District Court, the effective use of that information would have been mooted because of the state-imposed time clock. Many states have similar procedural time limits. Thus, the New York staff views recourse through the Federal District Court as a potential source of legal whiplash.

In contrast, regulators from other states that are geographically far removed from the SEC in Washington, DC view a trot across the street to their local district court as by far the best means of gaining access to information. The point is, conditions vary widely across the country, and a judicious course might provide each state with the option to choose the path of relief it sees as the most expeditious. Also, because of the factors such as the legislatively mandated time clock, New York State staff strongly opposes requiring that these information requests originate from an ongoing state proceeding. Only too frequently, these information requests are used to form the basis for initiating a proceeding, and the New York staff foresee a catch-22 quality to this requirement, or at least unnecessary delays in acquiring needed information. Obviously, there is a need to protect interstate utilities from frivolous requests from third party intervenors in state proceedings. One way of curing that problem is to require that all information requests be funneled through state utility regulatory commissions.

There is another provision in Section 3A(d) that is extremely troublesome to New York State. The provision provides that "nothing in this section shall subject a holding company or any associate company thereof to the jurisdiction of a state commission, except as specifically provided herein". While it appears that the intent of this paragraph (1) when combined with paragraph (2) is to limit the imposition of any additional reporting requirements on interstate holding companies, unless they are required by their own state authorities, I am concerned that paragraph (d) can be more broadly construed as a blanket Federal preemption of all state jurisdiction over holding companies. Note, as drafted, paragraph (d) includes all holding companies. There are holding companies that are essentially intrastate which the Act exempts from Federal purview under Section 3a(1),(2) and (6). They could fall through the cracks and escape regulation even by the states under this provision. It is unnecessary, and it should be eliminated.

I think the language included in this section to guarantee the confidentiality of sensitive business information is essential. I note that New York State currently has legislation in place which establishes procedures to guarantee the confidentiality of sensitive business plans and "trade secrets".

I think some ramifications of the proposed revisions to Sections 6 and 9 of the 1935 Act are desirable. If the intention is to establish some underlying, "no-harm" level of diversified investment by an interstate utility holding company which would be permitted without further scrutiny, I am in agreement. This would allow existing interstate companies to establish some track record with non-utility ventures, so regulators could gauge the potential impact, if any, of expansions on utility operations. This type of "trial marriage" is satisfactory so long as the threshold levels of investment are sufficiently small so that even if these ventures are complete failures, the holding company's ability to continue to provide safe and adequate utility service at reasonable costs is not impaired. Unfortunately, the way Section 6 is drafted, I feel those threshold levels may be somewhat vague, and in any event are far too large. I agree with Commissioner York that the percentages should be tied to net utility plant or rate base, not their capitalization, and I emphasize it should be restricted to investments in the utility side of the business. This, after all, is a reasonable index of the relative attention management will pay toward providing adequate utility service. Furthermore, I think 5%, not 10% is a prudent threshold level.* As an example, 5% of American Electric Power's net utility plant would allow them to invest $500 million in diversified non-utility ventures before SEC or state regulatory oversight is applicable. A 10% threshold would allow a $1 billion investment, which to my knowledge equals the single largest investment ever made by any non-utility private business in the U.S.: General Motors Corporation's investment in new production facilities to manufacture their X-body cars. Tying the percentage figure to holding company assets would merely enlarge the level of unscrutinized investment.

Moreover, revisions to Section 6 are drafted to permit the accumulation of waivers under sub-section (b)(1) (A) and (D). Thus, a holding company could structure an extremely large investment using more than one exempt security issuance and still remain exempt. As an example, the holding company can issue short-term debt for up to 10% of its aggregate capital and the utility can guarantee financing for another 10% of its aggregate capital. With this capital in place, the non-utility subsidiary is free to issue whatever additional securities it can without further SEC oversight. Again, I strongly urge you to restrict this limit to 5% (not 10%) in total and of utility rate base (not utility or holding company capitalization), thereby eliminating the possibility of accumulating waivers.

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* While in many cases the allowed dollar level of diversification would be similar, the New York staff strongly prefers establishing this threshold at 10% of the common equity invested in the operating utility. In that case, the holding company would be dissuaded from transferring equity from the utility to the diversified subsidiary, thereby increasing the financial risk to utility customers.

The SEC is also provided what appears to be a new power to exempt any security even if it does not qualify for an exemption explicitly under the law. The abuse of this power could be very injurious to ratepayers and I urge that Section 6(b) 3A be eliminated. The final technical problem with Section 6 is found in 6(b)(2). The standard the SEC must satisfy before it may impose restrictions on a holding company's capital structure is too restrictive and instead should be related to a flexible "public interest standard". Furthermore, the burden under sub-section 3(B) for further exemption should be placed on the utility and be not merely to show the absence of "an unreasonable economic risk to investors or consumers' but rather the ability to continue to provide safe and adequate service at reasonable costs.

The proposed amendments to Section 7, which specify procedures and waivers for filing and approving individual security issuances and/or security issuance plans, are so severely deficient that I am tempted to urge you to scrap this version and begin anew. The proposed Section 7 eliminates many of the findings the SEC is required to make before the declaration of an issuance may be approved. It also imposes a burden on the SEC to prove an "unreasonable economic risk" before it may approve a declaration.

In theory, I concur with that I believe may be the basic intent of this section, to permit speedy, and in most cases perfunctory approvals, that would in turn allow holding company managers greater financing flexibility and an opportunity to act quickly on favorable market conditions. I do not think a debate on the desirability of a particular investment should take place at the time of a proposed financing; rather, those concerns should be thrashed out in the review of the proposed biennial plan. However, it is critical that with this new flexibility, adequate safeguards also be installed. Individual financings should be reviewed briefly to determine whether they are consistent with the approved guidelines of the plan. This requires simultaneous noticing of all affected state bodies as well as the SEC and an open period affording an opportunity to comment that is somewhat longer than the proposed twenty days (perhaps forty-five). Of course, if no comments are received, these financings should be approved automatically at the end of that period. This permissive nature does, however, require that individual state commission's have the opportunity to comment on individual financings, and that those comments be considered before an order becomes final.

I feel that the language on Section 7(b)(1)(A)(B) is too perfunctory and imposes a great risk on state regulators; for it allows the Commission to preclude state comment if the utility holding company accepts a Commission preliminary order before any other party has responded. Similarly, Section 7(b)(5) permits the SEC to approve declarations in less time than the statutory requirements, which also could preempt state comment. In New York State, we have the legislative authority to approve each financing by our state's utilities; this language could preclude us, under certain circumstances, from having similar powers with respect to interstate utilities who might serve customers in New York. I recognize that in many cases speed is of the essence, and perhaps a compromise can be reached by requiring states to file a notice of intent to comment within ten days after a filing (provided, of course, we are served simultaneously with the filing). Otherwise, as these revisions are currently drafted, the SEC could issue its preliminary order which might then be made final without further opportunity to respond, if accepted by the declarant. Thus, the proposed amendments eliminate most of the necessary

Section 7 safeguards which protect utility customers from undesirable holding company financing.

Section 7 also distinguishes between seeking approval on a case-by-case basis for individual financings versus the filing of a financing plan. Some scrutiny of the financing plan option is provided which permits state participation, and I have no problem with that section. However, it seems that a holding company can escape this degree of scrutiny by opting for case-by-case financing approvals, and it is that opportunity which appears to be afforded by these amendments, which I feel would be unfortunate. Also, the minimum period for analyzing a comprehensive financing plan should be extended to ninety days.

My comments about a too generous threshold level also apply to Section 9 which imposes registration and reporting burdens on holding companies only if they have a "significant interest" in other companies. Again, sub-section (d)(1)(A) and (B) should establish that threshold investment at 5% of net utility plant (not total consolidated assets of the holding company nor 10% of the combined holding company assets together with all other interests).

In Section 10(g)(1) permissive language is introduced which allows a registered holding company to file a biennial diversification plan. While this addition is constructive, if the approvals of individual financings under Section 7 are to be weakened in reliance on a close scrutiny of the overall diversification plan, then it is absolutely essential that the biennial plan be mandatory. Here again, Commissioner York and I are in total agreement, and we also agree that the burden of proof should be placed on the holding company. A possible, no-harm burden would demonstrate that the plan does not portend a reasonable possibility that subsequent actions could impede the holding company's ability to continue to provide safe and reliable service at reasonable costs to their utility customers.

In the unlikely event that the divestiture powers contained under Section 11(b)(1)(B) are applied, I wholeheartedly agree that the burden of roof should be shifted to the Commission and state regulatory bodies to make a strong showing. However, the burden should not be merely that "retention of such interest materially adversely affects the public utility business" (which can be narrowly interpreted to mean its profitability) but that it also adversely affects the utility's ability to provide safe and adequate service at reasonable costs.

Section 11(h) deals with affiliate transactions of a holding company and permits the Commission to allow sales between a non-utility subsidiary and a utility either at cost or at comparable market price, if the latter is discernible. I can envision that some state commissions may want to approve a variety of other types of incentive contracts, which may fall somewhere in between these two alternatives. Therefore I suggest that these amendments include the flexibility to accommodate a variety of incentive contracts. As an example, some states could opt for a "split-the-savings" relationship where the cost to utility ratepayers are computed as the average of market price and cost. Under that circumstance, utility customers might actually pay more than market price if the cost of the project is excessive, but presumably they were willing to take that gamble since the customers would benefit had the project's cost been less than market price. So long as this amendment does not preclude individual states from making their own determination of the proper value of those transactions to be used for ratemaking purposes, I have less of a problem. But if the states are precluded from making their own determination as a result of an SEC decision, I would be unalterably opposed. One way in which the latter could happen would arise if the SEC approved transactions based on market price (my own preferred methodology), but the state policy was to use cost. In that instance, who would require the holding company to maintain its books and furnish its records so that the states could make an adequate determination of costs? The greater danger, in the case of a chain of affiliate transactions within a holding company, is that the costs are loaded up to a level that is far in excess of market value, so in this circumstance state commissions should also be free to examine the books and records purported to justify those costs, and the states should be free to base rates on market values even if the SEC had approved those transactions on a cost basis. Under all of the above circumstances, it is desirable to maintain the ability to approve a flexible range of contracts, but in doing so it is also obvious that state participation and comment is necessary before that SEC approval is granted.

Directly related to the increased ability to diversify provided by other amendments, is the proposed amendment to Section 12(a). That proposal would permit a parent holding company to borrow or receive an extension of credit or an indemnity from a subsidiary company in its system. The current law prohibits this activity because parent holding companies have systematically diverted needed monies away from local service territories. The potential for this abusive practice could be greatly increased with the loosening of the controls in other sections of the Act. The existing prohibition found in the Act should be retained. In addition, the same unreasonable standard I discussed earlier is imposed on the SEC before it may issue regulations to implement other provisions in Section 12. The current "public interest" standard should be maintained.

The new Section 34 which provides for the contemporaneous noticing of state commissions as well as the SEC is excellent; however, provision also should be added to notice state authorities regarding all financing or financing plans filed with the Commission under Section 7.

I will conclude my specific discussion of proposed amendments to the Act with several suggestions for additional provisions. Any modification of the Act exposes utility customers to some risk of increased monopolistic exploitation. Therefore, I strongly recommend that the Congress order the SEC to maintain an accounting of complaints, alleged abuses, problems and delays that occur after any amendments become effective, and to report their findings to the Congress annually. Furthermore, I urge the Congress to attach "sunset" provisions to any amendments, which would automatically revoke them at the end of five years after their effective date, unless the Congress made a specific finding, based upon the SEC reports, that these amendments had led to a minimal level of monopoly abuses.

Last year I pointed out the many asymmetries in the 1935 Act, including the different way in which diversification by an interstate utility holding company is treated as compared to intrastate companies. These amendments go a long way toward resolving that problem. However, the other asymmetry, the fact that only electric and gas utility holding companies are covered by the Act and not water and telephone still remains. Since last year, major changes have arisen in the telecommunications industry which could warrant your serious consideration of including landline telephone utilities under the aegis of this Act. In particular, in response to Judge Greene's ordered divestiture of the Bell operating companies from AT&T, AT&T has proposed to combine many of the local operating utilities into multi-state holding companies. Under this proposal, New York Telephone Company would be combined with the New England System, and the New York Commission is strongly opposed to this amalgamation because of the potential it creates for virtually unfettered diversification into non-utility activities by that holding company. Once that holding company is formed, each state loses its effective power of oversight on subsequent diversification activities and on the impacts that might have on the provision of basic utility service. It is anticipated that Judge Greene will rule on these proposals later on this month, and should he allow this consolidation to take place, I strongly urge you to consider the inclusion of landline telephone companies under the jurisdiction of the Public Utility Holding Company Act. Otherwise, I fear we will be back to 1935 again, but with a different utility.

Also, as I suggested last year, it would be advisable to provide a one year waiting period between the enactment of amendments to the 1935 Act and their effective dates. This would afford states the opportunity to alter their own state's regulatory laws, as they deem necessary, in order to continue to provide effective regulation in light of these changes.

III. Conclusions

On balance, what is to be gained by allowing interstate utilities to diversify and by amending the 1935 Act? In my view, not very much, but these are some of the possibilities: (1) an opportunity to share and spread managerial and administrative expertise and equipment and to gain some joint efficiencies in that area, (2) perhaps a gradually evolving more creative and entrepreneurial type of utility management, and (3) more flexibility in redeploying utility assets. These potential benefits must be weighed against the possible hazard of rapid escalation in utility rates because of uncontrolled monopoly abuses.

The second of the potential benefits listed above is the most appealing to me, but I doubt that few utility managers are supporting the creation of diversified holding companies so that they can be replaced by more enterprising individuals. In fact one of the regulators worst fears is that just the reverse may happen, that all of the talented employees will flock to the diversified non-utility activities, leaving the utility with the managerial dregs.

The third possible benefit has received little attention, but in a technologically evolving society, today's necessary utility may become tomorrow's outmoded albatross, and existing state and Federal utility law places a straitjacket on how a utility is to be phased out of business if it is no longer needed. In private corporate America, many operations are discontinued through an internal redeployment of assets if they are part of a larger conglomerate, and I see utility diversification as one avenue for accomplishing the same end, when desirable, thereby escaping thornier legal dilemmas.

Should interstate utilities be afforded the opportunity to diversify, I believe they should be given the further chance to establish a track record and to develop a sense of mutual trust between their customers, regulators, and other government officials, but in the long run only their actions can accomplish that.

I need not remind you that because of the rapid escalation in utility rates over the past decade, utilities are not the most popular institutions on the public rating charts. Neither are state regulators. In fact, the public frequently perceives that a conspiracy exists between regulators and utilities that is specifically designed for the exploitation of customers. That is why such extraordinary care is required in crafting these amendments; otherwise, the SEC and the U.S. Congress risk being characterized as co-conspirators.

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION
ALBANY

RICHARD E. SCHULER
COMMISSIONER

THREE ROCKEFELLER STATE PLAZA

June 21, 1983

Hon. Alfonse M. D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator D'Amato:

Again, thank you for the opportunity to appear before your Subcommittee on Securities to express my views on S.1174, Proposed Amendments to the Public Utility Holding Company Act of 1935. Attached are my responses to the additional written questions given to Commissioner York and me following our oral testimony last Tuesday.

Unfortunately, because of your busy schedule in the Senate Chamber, there were several additional salient points that I did not have an adequate opportunity to make. In your dialogue with Mr. Freedman, you expressed some concern over the continued financial difficulty of utilities. A year ago, that concern was proper; however, today a majority of utilities in this country are enjoying robust financial health, as indicated by their favorable recommendation by many investment advising houses. Note that this improvement was achieved without any modifications of PUHCA, but rather resulted primarily from reduced inflation and interest rates in the U.S. economy.

The perspective from which I have prepared my testimony and from which I have attempted to respond to your questions is: what residual protections are necessary within the SEC that would allow me to regulate a diversified, interstate utility in the same way that New York State law permits me to regulate a diversified intrastate utility?

I think we both share the concern about the Act's current asymmetry in its treatment of diversification by interstate and intrastate utilities. Thus, my stance would be permissive in nature, but note from my testimony that I do not see utility diversification as a panacea for these industries.

I appreciate the attempts in S. [illegible] address several of the regulatory concerns [illegible] expressed a year ago. My sense of unease, when looking at these proposed amendments in their entirety, is not that they do not contain specific language to deal with some of my concerns, but rather that in a multitude of separate small, apparently "minor" adjustments, more may have been taken away than was granted.

Unfortunately, with so complex a piece of legislation, no one can be entirely sure of its operational consequences ahead of time. That is why I feel one revision to the Act that I proposed in my testimony, is so important. Just as you have expressed a desire to allow these utilities to incur some threshold level of investment before SEC oversight becomes effective so that utilities and their regulators may establish some aura of mutual trust, so too I think, following any changes in the law, a period of formal review and re-evaluation may be desirable. Through periodic reports to the Congress, the absence of any overt abuses would become apparent to all parties. Thus, regulators might be more willing to accede to changes in the law, if they were assured that unforeseen consequences could be readily repaired. I sense that this proposed revision might also help nurture a sense of mutual trust.

In my rush to get my testimony forwarded in a timely fashion, one passage was omitted. This section proposes an update of the penalties contained in the Act in recognition of the unfortunate impact that fifty years's worth of inflation has had on the U.S. economy. These suggestions will be included in the corrected version of my testimony which is also attached.

Finally, New York State has attempted to encourage the deregulated construction of small hydro-electric and co-generation facilities, in accordance with Section 210 of the Public Utility Regulatory Policy Act (PURPA). In the future we may want to expand the deregulated generation concept to include base load facilities built and operated by any "non-utility" corporation. Thus, the definitions of utility may warrant revision, so that these generation companies would not fall under the provisions of PUHCA.

Please let me know if I can be of any help in your deliberations.

Sincerely,

Richard E. Schuler

Attachment

Richard E. Schuler
June 21, 1983

RESPONSES TO QUESTIONS FROM SENATOR D'AMATO ON S.1174

Panel 1 (State Utility Regulators)

Q. 1. On page 7 of your testimony, you indicate that some "no harm" level of diversified investment should be permitted without further scrutiny. Could you elaborate upon your comment?

How do you measure the level of diversification?

Would you restrict the nature of the diversified activities?

A. 1. In general, I believe some modest, threshold level of diversification into non-utility activities should be permitted before further investments are scrutinized by the SEC. This is intended to provide an experience base upon which all parties could judge the desirability of subsequent proposals. From a state regulator's perspective, this threshold should be based on a "no potential harm to utility ratepayers" criterion. In absolute terms, that level could reasonably set at 5% of net utility plant; however, as pointed out on page 8 of my testimony, a preferable gauge might be 10% of the equity invested in the operating utility. Under no circumstances should this be tied to asset or capitalization levels associated with the holding company.

One problem with the amendments as drafted is the asymmetry between the threshold level of investments allowed, on the one hand, and the amount of financing the company is allowed to accumulate in support of those investments. As drafted, the financing volume could be substantially larger, and therefore the amendments do not provide an effective restriction which limit diversifications within the investment guidelines. These problems are enumerated on pages 8 and 9 in my testimony.

Finally, I would not in general restrict the nature of diversified activities that are permitted under this threshold unless the activity might clearly have a negative impact on rates or quality of service. Note, that if a diversified investment is used for activities which are subject to anti-trust penalties, the potential financial risk could be far greater than ten percent of net utility plant if treble damages are awarded.

Q. 2. How would you modify this bill to ensure that state regulatory authorities have meaningful and adequate participation when the SEC is called upon to make decisions concerning the financing of diversification activities of holding company systems?

A. 2. I would require as I describe on pp. 10 and 11 simultaneous notice and filings of proposed issuances, declarations and plans on the states, including upstream financings under Section 12, with provision for comment to the SEC. Additionally, the vast, arbitrary

A. 2. Cont'd powers authorizing the SEC to exempt any security even if it does not qualify for an exemption (See p. 9 of my testimony); the power to bypass the time requirements to approve a filed declaration (See p. 10); and, the ability of a holding company to accept a preliminary order approving a declaration (p. 10); all these powers act to thwart state participation and protection of ratepayers.

Q. 3. Your suggestion for a delayed effectiveness of any amendments to the Holding Company Act in order to allow states to take whatever legislative and regulatory actions are appropriate.

Would it be necessary to delay all the amendments?

A. 3. I can only speak for New York State. Considering the complexity of the amendments, the downside risk to ratepayers if proper protections are not completely installed, and the lack of any compelling need to revise the Act (discussed below), I would recommend delaying all the amendments. In other words, piecemeal implementation could be very risky with no discernible benefits.

Q. 4. Isn't cross-subsidization best prevented by state regulation? What incentive is there for state regulators to permit cross-subsidization of a non-utility business by a utility?

A. 4. Obviously, state regulators are in the best position to prevent cross-subsidization of unregulated non-utility activities through enforced collection from monopoly ratepayers. In the case of interstate holding companies, that is precisely why the Public Utility Holding Company Act is required both to insure that state regulators have adequate information on both utility and non-utility activities and the power to intervene and comment before a potentially harmful action is taken by the company. Not only must PUHCA provide the states with an opportunity to comment and intervene on particular diversification proposals and on the terms of affiliate transactions between subsidiaries, it also offers a mechanism for the upfront review of the accounting methods that will be used to detect cross-subsidization. Subsequent monitoring to see that those procedures are adhered to is also absolutely necessary under this Act.

Furthermore, as I point out in my testimony on pages 5 and 6, the new absolute right of access to books through the Federal District Court, while providing a legal remedy of last resort, may in many instances be an ineffective practical device for insuring access to books and the monitoring of potential cross-subsidization. This is because of

A. 4. Contd the mandated time-clock imposed on most state regulatory decisions. Without a more rapid administrative procedure within the SEC to resolve information request dispites, the states' timely access to information may be effectively precluded. Again, let me emphasize, without PUHCA or other new Federal legislation, there is no way any state could protect their utility customers against cross-subsidization by interstate holding companies.

Q. 5. I understand the Alliance's concerns to be related to the possibility of cross-subsidization. Section 3A provides the state commissions with a new, federally guaranteed right to non-utility books and records. As a state commissioner, what incentive is there for you to increase utility rates so as to enable a utility to cross-subsidize its non-utility business?

A. 5. There is absolutely no incentive for state regulators to raise utility rates in order to subsidize non-utility activities, unless they are eager to face a firing squad at dawn. However, if small contractors are concerned by such a possibility, it again argues strongly for imposing Federal safeguards within PUHCA that establish the necessary accounting rules and access to books, for all affected parties. Nothing

A. 5. Contd inhibits cross-subsidization like a good dose of fresh air.

Q. 6. Last year, NARUC testified in opposition to repeal or substantial amendment of the Holding Company Act. Doesn't this legislation specifically address many of the concerns you raised last year? Don't you think this legislation represents a rather substantial compromise on the part of the utility industry?

A. 6. While I appreciate the fact that this proposed legislation "addresses" many of the regulatory concerns I raised a year ago, as I elaborated upon in some detail in my testimony, I am concerned that what appears to be provided on the one hand, is taken away on the other through a multitude of small, "seemingly technical" amendments. It is the weight of those many "minor" amendments that concerns me.

However, I do get a sense that we may be moving in the same direction. So long as we agree on the principles of (1) rapid and convenient access to books, (2) a mandatory biennial detailed review of the holding company's diversification plan and (3) subsequent review of individual financings to assure their conformance to the plan, coupled with

A. 6. Contd the proper allocation of the burden of proof on the utility, except where a divestiture is to be ordered, then I am confident the details can eventually be worked out to accomplish the desired objectives.

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION
ALBANY

RICHARD E. SCHULER
COMMISSIONER

THREE ROCKEFELLER STATE PLAZA

June 29, 1983

Hon. Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking, Housing
and Urban Affairs
Washington, DC 20510

Dear Senator D'Amato:

My response to Senator Mattingly's question regarding S.1174 is as follows:

Question:

You have stated that you believe S.1174 should be modified to require a utility company seeking an exemption from the Act to demonstrate that the exemption will not materially adversely affect the public utility business. It seems to me that it would be very difficult for a company to gather facts that prove that something will not happen. Is it fair to withhold an exemption unless a company is able to prove a "negative"?

Answer:

First, in my testimony I did not advocate that the utility be required "to demonstrate that the exemption will not materially adversely affect the public utility business." That is the type of burden that S.1174 would place on the Commission in order to deny an exemption. The Commission should not have such an overly stringent burden for two reasons. First, it is the utility or holding company requesting the exemption that should have the burden of showing that such an exemption is reasonable. In other words, S.1174 places the burden on the wrong party. Second, the requirement in S.1174 is too stringent.

On page 5 of my testimony I state "the proper burden should be placed on the utility or holding company to show that the intended action will at the very least result in no harm to utility customers." Philosophically, I agree with the thrust of Senator Mattingly's question; it is very difficult to prove that something will not happen, but it is also very difficult to prove that it will.

The major difficulty with this type of test is that it requires a showing based on a forecast, not that it forces someone to prove a negative. For example, as currently drafted S.1174 requires the Commission to find that the exemption will cause harm. It is very difficult to make that positive finding because it must be predicated on something that may happen in the future.

So, the burden of proof will be difficult to meet because of its speculative nature no matter on whose shoulder it is placed. Normally, in a free enterprise economy, I would argue, therefore, that the burden should be placed on government before interference with the private economy is warranted. In this case, however, where that industry is a natural monopoly with the innate ability to inflict substantial harm on society, the procedure should be the reverse.

On a practical level, it seems to me that one way a utility could make a no harm showing would be to demonstrate that the ability of state commissions to regulate holding companies effectively would not be impeded by granting an exemption. Obviously, if the effected state regulatory commissions concurred, the exemption should probably be granted. In fact, this may have been the implicit basis in the past for granting exemptions to intrastate holding companies.

Please let me know if I can be of any further help in evaluating these issues.

Sincerely,

Richard E. Schuler

Mr. LEVIN. In the interest of time, Senator D'Amato has authorized me to reconvene the hearing. I would like to call the next panel up. We have Mr. Burdette, Mr. Norton, Mr. Hottel, Mr. Farruggia, and Mr. Sapio.

On behalf of Senator D'Amato, may I welcome you all here today, in the interest of time, if you would like to start your testimony.

STATEMENT OF T. E. NORTON, VICE PRESIDENT OF MARKETING, PAINE SUPPLY COMPANIES, JACKSON, MISS., ON BEHALF OF THE AMERICAN SUPPLY ASSOCIATION

Mr. NORTON. Acting Chairman, thank you very much for the invitation to be here today.

Senator D'AMATO. Mr. Norton, I'm going to receive your testimony as if read in its entirety. I thank you because it's well thought out and documented.

Let me bring you to page 9, if I might, of your statement.

Mr. NORTON. The statement I have before me is an abbreviated version of the complete statement and the page numbers don't correspond. I'll have to turn to the complete statement to find where you are.

Senator D'AMATO. Let me read it for you. "We would not oppose this legislation if sufficient restrictions were placed on those activities so closely related to their existing customer base. Specifically, we believe that both registered and exempt companies must be subject to close public scrutiny when engaging in the business of supplying, installing, or maintaining gas or electric products and systems. There must be both prior and subsequent regulatory jurisdiction over such activities, including substantive provisions to protect against anticompetitive practices and cross-subsidization."

And then you go on to say that "Let me close by stressing as forcefully as I can that this legislation is not simply a securities bill. It is also legislation which would have a serious and far-reaching impact upon small and independent businesses throughout the country."

Mr. NORTON. Yes, sir.

Senator D'AMATO. I would suggest to you—and I don't say this in a defensive manner—that in the 2 years that I have been here as a Senator, I don't think there is anyone who has sponsored more small business oriented legislation than myself. I think I have been a good friend and a close supporter of small businesses and I have taken on the administration with respect to legislation that I thought was necessary to protect and nurture small business. Therefore I believe that what you say on page 9 is essentially correct. It is absolutely essential that we prevent anticompetitive tie-ins, because they have a detrimental impact on small businesses. The culprit however is not the proposed S. 1174. Those problems that you refer to are taking place today and would exist even in the absence of S. 1174.

In the fall the Small Business Committee will be holding hearings. I'm a member of that Small Business Committee and I think that we've got to develop legislation, whether it be through the Small Business Committee or the Judiciary Committee, to provide sufficient protections from the problems that exist today. That's without amending the PUHCA law. So to say that these problems are a result of or would be exacerbated by S. 1174 is reaching a little bit.

A more accurate statement is that there is a problem which we are concerned about and that it will continue to grow unless we do something to enhance or protect fair competition. I think S. 1174 goes a long way, and it does answer some of the outstanding problems; we want to see our utilities be successful, but not at the expense of small business. Certainly we should encourage the broader activities provided that there is fair competition. I think that small business and that your association's members can probably take on the big boys any time as long as there's fair competition. You should be concerned about this but I look forward to trying to work with you in developing legislation or language or an amendment, whether it be here or whether it be at the Small Business Committee, that would deal with the existing problem.

Mr. NORTON. Well, we appreciate that, Senator, and we certainly aren't categorically opposed to S. 1174. There are obviously some parts of the bill which bother us or we wouldn't be here and we appreciate your efforts in the past on behalf of small business and we appreciate the fact that you have invited us to speak this morning and allowed us to submit testimony.

Senator D'AMATO. Well, I just wanted to make that point before that buzzer goes off. I wanted to have that little dialog with you prior to leaving to vote. I thank you for your forbearance. If you want to complete your statement that would be fine. In any event we will put it in the record.

Mr. NORTON. That will be fine.

[The complete statement and response to written questions follow:]

Statement of the

American Supply Association

Presented by

T. E. Norton
The Paine Supply Companies

Mr. Chairman, thank you very much for your invitation to appear here today. I am Tom Norton, Vice-President of Marketing for the Paine Supply Companies in Jackson, Mississippi, and I am testifying on behalf of the American Supply Association.

ASA is the single national association representing wholesalers and distributors of plumbing, heating and cooling products, appliances and systems. The 1200 members of ASA have four thousand businesses located in all fifty states. Our customers are the contractors that service and install equipment and systems as well as commercial, institutional and industrial users.

I am joined here by representatives of four contractor groups. Our five associations are part of the Alliance for Fair Competition. The Alliance is comprised of fourteen national associations representing over 100,000 small businesses.

Throughout the country, gas and electric utility companies have ventured from the production and distribution of energy into the sale, installation and service of gas and electric appliances, products and systems. The Alliance for Fair Competition was formed to combat those utility practices which are unfair, anticompetitive and adversely impact the economic viability of small businesses.

Utility ventures into traditional wholesale, retail and contracting functions must be closely scrutinized because:

(1) Such programs are often and easily subsidized by passing through part of the costs to all ratepayers. A utility's rates will often absorb many of the research, development, administrative, marketing and product costs.

(2) When competing head to head with small businesses for the same customer, utilities--because of their protected monopoly status--enjoy a massive marketing advantage through their penetration into every home, office building and factory.

(3) Utility involvement in sales, installation and service of gas and electric products and systems to their customer base ensures a continued demand for their primary product to those same customers--energy.

It was stated last year at a similar hearing before this subcommittee that utility companies were not interested in sale or installation programs. I would direct the Subcommittee to a May 1981 report of the Edison Electric Institute on Utility Diversification, which lists appliance programs as one of the six areas most often entered into by utilities. Our members are battling unfair utility practices throughout the country. Unfair competition is the subject of court cases, public service commission proceedings and legislative initiatives. This fall the Senate Small Business Committee will hold hearings on this very subject.

We come before you today to register our grave concern over S.1174, which, if enacted, would exacerbate an already serious problem for thousands of small businesses. The effect of this proposed amendment to the Public Utility Holding Company Act would be to allow utilities to diversify into our industry virtually unchecked. Not only would it remove SEC jurisdiction over most of the diversification activities of the twelve registered holding companies, but it also would eliminate the constraints which the exempt companies must contend with, as well. It also makes the holding company structure much more attractive to those operating companies not presently organized as holding companies.

We do not contend that PUHCA in its present form is the most effective, sensible way to deal with the problem of competition. Far from it. But the Act, as well as the case law interpreting the Act, does provide procedures and protections relevant to our concerns.

In order to receive SEC approval of diversification activities under the current Act, registered companies must meet the "functionally related" standard--a two-pronged test requiring that the activity be incidental to the utility operation and that it be in the public interest. And although the SEC and the holding companies have told this Subcommittee that appliance sales programs are functionally related, there actually exist very few decisions addressing the issue of under what circumstances the sale or installation of appliances may constitute "functionally related" businesses to satisfy the Act. While there have been instances over the past 40 years where appliance merchandising has been permitted under the "functionally related" standard, never has the SEC given blanket or automatic approval to utilities to venture into these areas. In those few cases which discuss the issue, the presence or absence of certain factors was critical to the determination of whether or not the appliance merchandising operation met the "functionally related" test.

In fact, the SEC's often quoted statement that appliance merchandising has long been considered "functionally related" is based primarily upon one

1942 case. In Engineers Public Sevice Company, 12 SEC 41 (1942), the Commission did allow an electric utility to retain an electric appliance merchandising business. However, the court pointed to specific factors which made the business permissible, including the fact that the business was designed to educate the public in the use of electricity and consisted mostly of appliances with which the public was not familiar.

In General Public Utilities Corporation, Holding Company Act Release No. 15157 (November 27, 1964), the Commission permitted the acquisition by a registered holding company of stock and notes of a company organized to promote on a national scale the manufacture and marketing of electrical equipment employing a new kind of fan. The SEC allowed the utility to assist the company only through the developmental and demonstration stages for its products and the SEC order included a condition that GPU divest itself of the business within three years after acquisition.

Under these prior SEC decisions, the language used demonstrates that appliance merchandising in and of itself is not necessarily "functionally related" in all cases. Whether or not it is will depend upon such factors as the purpose of the business, whether it's conducted for profit and how it relates to the business of operating a utility system. And even if it allows the utilities to conduct such a business, the SEC can place conditions upon that involvement and continue to oversee their conduct of the business.

Moreover, it must be kept in mind that even if an appliance merchandising business does satisfy the first prong of the PUHCA test, i.e., incidental to the utility operation, it still must pass the second part of the standard: whether the business is reasonably necessary or appropriate in the public interest or for the protection of investors or consumers.

What is in the "public interest" is a fluid concept, which necessarily changes over time. In the economic realities of the 1940's, it may not have been detrimental to the public interest for utilities to engage in appliance merchandising. However, a particular merchandising or installation operation in the 1980's or 90's may be found not to be in the public interest when such an operation is used, for example, to stimulate energy conversion by residential, industrial and commercial users--especially in light of the vulnerable state of the various energy sources available and the susceptibility to fluctuation in the supplies and prices of these sources over time. Nor would it necessarily be in the public interest if the end result is that the utilities are able to use their monopolistic position to destroy fair and open competition in the marketplace.

Another mistaken notion expressed at last year's hearing was that competitive factors are irrelevant to PUHCA. That simply is not true. The Supreme Court has stated that the theme of elimination of restraints on free and independent competition runs throughout the Act. S.E.C. v. New England Electric System, 384 U.S. 176 (1965). In another case, Municipal Electric Association of Massachusetts v. S.E.C., 134 U.S. App. D.C. 145, 413 F.2d 1052 (1969), the court required the SEC to consider anticompetitive factors in determining what is in the public interest, ruling that §10(b)(1) of the Act must take significant content "from the federal antitrust policies."

Again, we are not suggesting that PUHCA is the best or most effective method to guard against the anti-competitive activities which ASA fears. However, until some other meaningful forum is created, PUHCA must remain intact. The state commissions do not have the manpower, resources, or, in some cases, the authority to guard against the abuses which are bound to result if S.1174 were enacted.

To prevent utilities from abusing their position as a protected monopoly when pursuing diversification activities, it is essential that there exist procedures for prior approval, protections against anticompetitive practices, and continued jurisdiction over the diversified business. The effect of S.1174 as it relates to diversification would be threefold. First, it would eliminate SEC regulation of the diversification activities of the registered companies. Second, it would also remove the "passive" control which the SEC exercises over the diversification operations of the exempt holding company system through the "unless and except" clause. Third--and perhaps one of the most dangerous consequences of all--it would give utility companies an escape mechanism to bypass state regulation.

Let me explain how this escape mechanism works. When a utility chooses to do business in non-utility areas, it has two alternatives. The first option is to create a subsidiary of the utility (or, of course, conduct the business as a part of the utility)--in which case the non-utility subsidiary would be subject to state public service commission approval and oversight in most states.

The second alternative is to create a holding company on top of the utility so that non-utility operations can be placed in subsidiaries of the holding company rather than of the utility. In many states, the public service commission will not have control over the establishment or operations of these non-utility holding company subsidiaries--except when the subsidiary is selling goods and services to the utility. In this way, the holding company structure can be used to escape state regulation.

However, under current law this "escape mechanism" is not as advantageous as it otherwise might be, since the use of the holding company structure runs the utility into a whole new layer of federal regulation--namely, PUHCA. If the holding company and the utility operations exist in more than one state, the holding company will have to register with the SEC as a public utility holding company and become subject to the full range of PUHCA restrictions and requirements. On the other hand, if the holding company structure is intrastate, it may qualify as an exempt public utility holding company.

Even so, the non-utility portion of the exempt holding company operations will not be left entirely without scrutiny, since exempt holding companies are still subject to the "unless and except clause" in PUHCA. This "unless and except" clause provides a measure of control over the holding company's diversification operations. That the SEC also views the unless and except clause as imposing a limit upon diversification activities of exempt holding companies is evident from the Lykes Brothers case, Lykes Brothers, Inc., SEC Holding Company Act Release No. 20487 (April 6, 1978).

Thus, the very existence of PUHCA--even with its many inadequacies--discourages widespread use of the holding company structure by utilities to avoid state regulation. Without PUHCA, there would be nothing to stop utilities from evading effective state regulation by manipulating the holding company structure to their advantage. This use of the holding company structure as an "escape mechanism" was recognized by the Director of the SEC Division of Corporate Regulation at a symposium on utility diversification:

> "The holding company is not simply a means of securing diversification through the exempt provisions of the Holding Company Act. The holding company is itself an attempt to escape regulation by the states themselves. And I think it's important to recognize that."[1]

The state commissions are ill-equipped to regulate diversification activities effectively when confronted with the holding company structure--even in those states which specifically grant their commissions authority to approve and oversee non-utility diversification. At a Senate hearing last year, a NARUC spokesman referred to this problem:

> "One thing is clear. If we allow a holding company to be built on top of the operating utility itself, we lose effective control of all subsequent investments in non-utility operations by that company. In other words, once we make the threshold decision that a holding company can go on top of the utility, then they can form many additional non-utility subsidiaries without additional state approval."[2]

By removing most federal regulation of the public utility holding company's diversification activities and, at the same time, granting utilities an "escape mechanism", passage of S.1174 would give utilities free rein to do as they please when pursuing diversification. The potential for abuse is just too great to allow that to happen.

Mr. Chairman, we do oppose S.1174 as written. But we do not categorically oppose amending PUHCA. We have no disagreement with much of what is contained in S.1174.

We would not oppose this legislation if sufficient restrictions were placed on those activities so closely related to their existing customer base. Specifically, we believe that both registered and exempt companies must be subject to close public scrutiny when engaging in the business of supplying, installing or maintaining gas or electric products and systems. There must be both prior and subsequent regulatory jurisdiction over such activities, including substantive provisions to protect against anticompetitive practices and cross-subsidization.

Mr. Chairman, let me close by stressing as forcefully as I can that this legislation is not simply a securities bill. It is also legislation which would have a serious and far-reaching impact upon small and independent businesses throughout the country.

Again, thank you very much for your invitation to appear here today and for your efforts in the last months to resolve our concerns with this legislation.

FOOTNOTES

[1] *Utility Diversification, Strategies and Issues*, June 1981 (New York), p. 51.

[2] Statement of the National Association of Regulatory Utility Commissioners before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee on S.1869, S.1870, S.1871 and S.1977, June 10, 1982 at p. 501.

Members of the Alliance for Fair Competition

Air Conditioning Contractors of America

American Consulting Engineers Council

American Supply Association

Associated Specialty Contractors

Independent Electrical Contractors

Mechanical Contractors Association of America

National Association of Plumbing-Heating-Cooling Contractors

National Construction Industry Council

National Oil Jobbers Council

National Association of the Remodeling Industry

National Electrical Contractors Association

Northamerican Heating and Airconditioning Wholesalers

Plumbing Manufacturers Institute

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Heating, Cooling and [illegible]
Products Wholesalers

American Supply Association
221 N. LaSalle Street
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312/236-4082

Peter W. Schwartz
Executive Vice President

July 20, 1983

Responses to Questions Submitted by the Subcommitee on Securities to the American Supply Association Regarding S.1174, The Public Utility Holding Company Act Amendments of 1983

1. Who should be charged with the responsibility of policing subsidiaries in order to eliminate illegal unfair competitive practices, the Federal Trade Commission, the Justice Department, the Small Business Administration or the Securities and Exchange Commission? Please evaluate the strengths and weaknesses of charging each one of these agencies with enforcement powers.

The state public service commissions should have the primary responsibility for policing holding company subsidiaries. Many of the problems of cross-subsidization and unfair competition are best addressed at the state and local level, where those affected are able to participate in the regulatory proceedings. If a federal government agency were to have this primary responsibility, we believe that the federal agency would lack the necessary perspective of how a local utility's practice is impacting on local suppliers and contractors.

The difficulty with the state public service commissions, however, is that many states lack the authority in their state public service acts to consider competition questions. Furthermore, many state commissions perceive their role as protecting the interests of ratepayers, interests which often will be in conflict with the interests of small business and a competitive marketplace. Therefore, it is imperative that a federal agency have the clearly defined responsibility and authority to address "alleged unfair competitive practices." The FTC has such authority in Section 5 of the FTC Act, but needs to be provided a reminder by the Congress. In our discussions with the FTC, it has been their feeling that the "state action doctrine" applies, which preempts federal authority over those entities already regulated by state agencies.

We also feel that the Chief Counsel for Advocacy at the Small Business Administration should have a consultative role because many utility business practices, while outside the scope of the FTC Act, are detrimental to small business and the competitive marketplace.

2. Under current law, public utilities, both regulated and non-regulated, are permitted to diversify. This bill would provide broader diversification latitude to a relatively small number of utility holding companies. Therefore, it seems that your problem predates these amendments and will exist even if these amendments are not enacted.

Yes, problems faced by suppliers and contractors do predate these amendments. However, as we testified before the Securities Subcommittee, the existing Act, as well as the case law interpreting the Act, does provide procedures and protections relevant to our concern. In order to receive approval of diversification activies under the current Act, registered companies must meet the "functionally related" standard--a two pronged test requiring that the activity be incidental to the utility operation and that it be in the public interest. While the SEC, the holding companies and possibly the Committee disagree with our view of the "functionally related" standard, we must stress that our review of this year's hearing record as well as last year's record indicates that neither the SEC nor the utilities have provided any substantiation for their position. If the Committee chooses to disagree with our position, we would hope that you would require the utilities and the SEC to substantiate their interpretation of the "functionally related" standard.

In the first question, we stated our belief that the state public service commissions should have the primary authority. S.1174, however, provides an escape mechanism for utilities, through their use of the holding company structure, to bypass state regulators. On page 8 of Mr. Norton's testimony are statements by both the SEC and NARUC on this very point. We would hope that the Committee will take a closer look at this possibility before any further consideration of this bill.

To summarize, while our "problem" predates these amendments, these amendments will exacerbate an already serious problem.

What possible remedies are available to the states in cases of unfair competition from utilities?

Remedies exist in those states where the state commissions have the authority to consider question of competition. In many states, including New York, the state commissions either don't have the necessary authority or have chosen not to exercise that authority. In the recent LILCO proceeding in New York State, the New York State Public Service Commission not only refused to consider the request of LILCO's proposal on competition but also turned down an appeal from the New York Attorney General on this point.

Have you ever engaged in private litigation?

It is my understanding that there are several court cases currently pending.

Have you ever contacted the Justice Department or the Small Business Administration?

We have worked very closely with the Chief Counsel at SBA over the last two years. His office took an active role, at our request, with both the New York Public Service Commission and DOE during the LILCO proceeding.

3. Isn't cross subsidization best prevented by state regulators? What can the state regulators do about unfair competition that doesn't involve cross-subsidization?

Yes, cross-subsidization is best prevented by state regulation. However, many states lack the necessary manpower to carefully scrutinize all utility practices. Also, the states will often encourage cross-subsidization if such subsidization would benefit the ratepayers, without giving consideration to the impact on competition. A balanced public policy is necessary to ensure that ratepayers, investors and competitors receive equal consideration in the approval and review process of holding company acquisitions. The Congress should take action to set specific standards which define those practices which are anticompetitive and/or impermissible cross-subsidization.

4. Why aren't the antitrust laws the answer to the competitive "problems" your statement identifies?

Federal antitrust laws are only part of the answer to the problems confronting suppliers and contractors. There are four major drawbacks with federal antitrust laws. (1) Enforcement of antitrust is intensely political and dependent on the attitude of the current Administration and current make-up of the Congress. This is not all bad, for it allows the concept of antitrust to be fluid and responsive to the times. However, this approach to antitrust is not one that provides much measure of protection or reassurance to a small supplier fighting his utility in upstate New York, for example. (2) Antitrust litigation is time-consuming and expensive. By the time a case has wound its way through the courts, a small businessman may well be out of business. (3) A major factor in the ability of a utility to maintain a competitive advantage over its competitors is the use of its protected monopoly position in the marketplace. The competitive advantage which accrues to the utility may not always be in conflict with antitrust law, but is in conflict with the public interest and good, fair public policy. This is a major reason that I appeared before your subcommittee, because of the possible impact of S. 1174 on public policy. (4) Both the utilities and the federal agencies continue to hide behind the "state action" doctrine, which preempts federal authority over state regulated entities.

Senator D'AMATO. Mr. Burdette.

STATEMENT OF C. T. BURDETTE, PRESIDENT, POWER PRODUCTS, INC., MACON, GA., ON BEHALF OF THE NATIONAL ELECTRICAL CONTRACTORS ASSOCIATION

[The complete statement follows:]

Statement of Mr. C.T. Burdette, President
Power Products, Inc., Macon, Georgia
Speaking on behalf of the
National Electrical Contractors Association
before the
Senate Banking, Housing and Urban Affairs Subcommittee on Securities
in regard to
S. 1174, the Public Utility Holding Company Act Amendments of 1983

June 14, 1983

Mr. Chairman, Members of the Committee, I am Charles Burdette, President of Power Products, Inc. of Macon, Georgia. I am here today speaking on behalf of the National Electrical Contractors Association -- a trade association representing the interests of the nation's $25 billion electrical construction industry, its nearly 40,000 firms and the more than half million electrical workers they employ.

Quite frankly the aspects of this proposed legislation which would allow utility holding companies to diversify more easily than is the case under the 1935 Act are frightening to electrical contractors. Over the years we have noted an abundance of instances where electric utilities have used their size and special protected status to engage in promotional practices which were economically devastating to the mostly small business electrical contractors in their areas. In many cases the effects were unintentional, but unprotected small business was injured just the same.

It is my belief, and that of the organization I represent here, that the legislation being considered, without substantial and adequate safeguards against unfair, deceptive or anti-competitive acts or practices, represents a substantial hazard to our industry. Utilities are granted certain perquisites as local monopolies. Their investors or the investors in the holding company which controls the utility reap the benefits of this special status. The utility exists as a monopoly to serve a public need. The holding company exists as an investment tool. The holding company is tied, like it or not, to the utility and its public mission and its special status. In diversifying, there is no way, without adequate legal safeguards, that a utility holding company can avoid the implied and actual anticompetitive impact that its financial strength, its ratepayer base, its monopoly status and its publicly-granted perquisites give it in a free market. In other words, a business tied to a utility -- either directly or through a holding company -- has both explicit and implicit advantages over other firms in that market.

I have first hand experience with the potential abuses which can occur. The Southern Company is a regulated utility holding company. It owns Georgia Power Company. It recently established a subsidiary company in the electrical construction field, Southern Electric International. Contractors were concerned about the establishment of this firm. It has the financial backing of Georgia Power to draw upon, while other contractors have to build their own financial base. In many cases whether a contractor's bid is successful or whether he is even allowed to bid is determined by his financial strength. Thus, Southern Electric International had an innate competitive advantage at the very outset of its operations.

Those of us who were concerned met with representatives of Georgia Power and the Southern Company. We were told that we had nothing to fear. The electrical construction subsidiary was being formed only to bid work outside the United States ...to assist third world countries, particularly in the Caribbean, and to compete with European state-supported electrical construction firms.

We were told, in addition, that Southern Electric International (SEI) would be using personnel and equipment from Georgia Power Company and, possibly, Alabama Power Company on their projects. They acknowledged that, while SEI would be backcharged for use of power company personnel and equipment, the profits would go directly to Southern Company stockholders and would, in no way, benefit the rate-payers of Georgia. Thus, SEI had the benefit of a trained pool of men whose existence and availability was underwritten by the Georgia Power Company's rate payer base.

Despite these assurances, it was not long before we encountered SEI in a competitive situation...and it was not in a third world country, but in Tallahassee, Florida. SEI was submitting a bid on construction of a 230 kV transmission line for the City of Tallahassee. Our firm was another bidder on that project. SEI's bid had been prepared and submitted by engineers who were full-time employees of the Georgia Power Company. The bid was actually submitted in a Georgia Power Company envelope! At the bid opening, the bid was announced to be that of Georgia Power Company not of SEI.

Since that time, I have encountered SEI bidding on two other electrical projects, both for the U.S. Navy at Kings Bay, Georgia. While SEI was not successful in its bid for the Tallahassee project, the withering effects if its relationship with Georgia Power on other competition were frightening. Both the explicit use of Georgia Power personnel, materials and financial strength, and the implicit advantage of such publicly displayed ties scare off smaller competition. The longer the situation is allowed to exist, the more damage will be done to the competitive atmosphere and the entire electrical construction market. The financial ties are not lost on either potential clients or potential competitors.

In this instance, the ties were acknowledged by the utility itself. A simple admonition to holding companies to avoid such ties will only force the relationship among utility, holding company and subsidiary to become more circumspect... it would not eliminate it.

What is needed is substantial legal protection for firms which must compete in the free market on their own from such use of rate-payer supported and publicly granted competitive advantages that firms tied to utilities enjoy.

The National Electrical Contractors Association urges you to give the most urgent and careful consideration to language which would provide the fullest protection for such vulnerable firms from the potential and actual deceptive, anti-competitive and unfair practices we have observed taking place in the relationship of the Southern Company, Georgia Power Company and Southern Electric International. With such protection, we can give our support to this legislation. Without it we must strongly oppose the legislation.

Thank you for allowing me this opportunity to testify.

Mr. LEVIN. Thank you, Mr. Burdette.
Mr. Hottel.

STATEMENT OF RICHARD HOTTEL, PRESIDENT, HARVEY W. HOTTEL, INC., ROCKVILLE, MD., ON BEHALF OF THE AIR CONDITIONING CONTRACTORS OF AMERICA

[The complete statement follows:]

Air Conditioning Contractors of America

Serving the
Independent
Refrigeration,
Heating and
Air Conditioning Contractor

Statement
presented to the
Subcommittee on Securities
Committee on Banking, Housing, and Urban Affairs
United States Senate
on
Amendments to the
Public Utility Holding Company Act
(S. 1174)

by the
Air Conditioning Contactors of America

Presented by:
Richard Hottel, President
Harvey W. Hottel, Inc.

Tuesday, June 14, 1983

1228 17th Street, N.W. Washington, D.C. 20036 (202) 296-7610

Air Conditioning Contractors of America

Serving the
Independent
Refrigeration,
Heating and
Air Conditioning Contractor

Mr. Chairman,

Thank you for your invitation to appear here today. I am the President of Harvey W. Hottel, Inc., an engineering and contracting firm which specializes in the design and build of industrial and commercial refrigeration and air conditioning systems.

I am testifying in behalf of the Air Conditioning Contractors of America. ACCA is a national association of independent contractors who sell, install, and maintain heating, air conditioning, ventilation, and refrigeration systems.

ACCA contractors are involved in residential, commercial, and industrial markets in new construction and retrofit projects.

ACCA contractors vigorously compete to make a profit in today's depressed construction industry. However, an important point I'd like to make is that, competition, in itself is not frightening to a small businessman like myself.

1228 17th Street, N.W. Washington, D.C. 20036 (202) 296-7610

What is frightening, no, terrifying for a small businessman is unfair competition.

Mr. Chairman, you are, no doubt, aware of the types of concerns a small businessman might have when confronted with competition from his public utility or its holding company. A public utility's financial assets, name recognition, residential and commercial access, marketing and advertising resources, all add up to a tremendous advantage over my company or any independent business.

But let me briefly describe a situation I have been forced into because my public utility, Washington Gas & Light, decided to branch out into the energy management field.

Washington Gas & Light while not part of a holding company, at this time, might very well be if S. 1174 is passed. Regardless, Washington Gas & Light's activities in the energy management business will illustrate the fear I, and thousands of others, have about anti-competitive and deceptive activities on the part of these big businesses.

My company is recognized as a leader in the relatively new field of energy management. I was one of three dealers for Andover Controls. Andover Controls manufactures energy management systems, which in my opinion, are one of the best in the market today. I was the Washington area dealer for this equipment. There was also a dealer in Baltimore and one in Virginia.

You will note the past tense, "was", because Mr. Chairman, Hottel Energy along with the other two dealers were recently informed by Andover Controls that we would no longer be dealers for their equipment.

This in itself was very hard for me to believe or accept, because I had been an excellent customer of theirs for the past two years. But, even more incomprehensible to me and my two competitors was that Washingtion Gas & Light would now be the **sole distributor** of Andover Controls' equipment in the Washington, Maryland, and Virginia area.

Simply stated, if I am to continue to pursue energy management jobs for my company - I will now have to bid against Washington Gas & Light and what's more - I'll have to buy the equipment from Washington Gas & Light. It certainly leaves me at a considerable bid disadvantage.

My immediate question, of course, is why wasn't Washington Gas & Light satisfied at becoming just another distributor along with the rest of us? Washington Gas & Light could have been a dealer just like I was. Why was Washington Gas & Light made the only dealer for this market area? Hottel Energy was not offered such exclusive rights, nor was Engineered Services, Inc. of Virginia, nor was the dealer in Baltimore.

Mr. Chairman, this is just one example of how a public utility or holding company can alter normal market conditions to create an anti-competitive climate for small businesses. ACCA will submit written comments to address our full concerns with S. 1174 and the possible opportunities it provides for utilities and holding companies to engage in anti-competitive, unfair, or deceptive activities.

Thank you, Mr. Chairman, for your continued commitment to protecting small business interests and for allowing me this opportunity to express my concerns.

Mr. LEVINE. Thank you, Mr. Hottel.
Mr. Farruggia.

STATEMENT OF SAL FARRUGGIA, PRESIDENT, GARNET PLUMBING CO., PERRINVILLE, N.J., ON BEHALF OF THE NATIONAL ASSOCIATION OF PLUMBING, HEATING & COOLING CONTRACTORS

[The complete statement follows:]

PHCC NATIONAL ASSOCIATION OF PLUMBING • HEATING • COOLING CONTRACTORS
1016 20th STREET, N.W., WASHINGTON, D.C. 20036 • (202) 331-7675

Statement presented to the

Securities Subcommittee

Committee on Banking, Housing, and Urban Affairs

United States Senate

on

S.1174 - Amendments to the Public Utility Holding Company Act

by the

National Association of Plumbing-Heating-Cooling-Contractors
Presented by:

Sal Farruggia, President
Garnet Plumbing Company
Energy-Wise HVAC

For the Legislative Committee:
Leonard X. Farbman, Chairman, New York
Roger Peugeot, Kansas
Karl Ruch, Florida
Gerald Staas, Texas
Art Barrington, California
William L. Harvey, Oregon
James E. Curry, Jr., Massachusetts

Tuesday, June 14, 1983

Mr. Chairman, my name is Sal Farruggia and I am the owner of two small business contracting companies in Perrineville, New Jersey. One is Garnet Plumbing Company which is a 15 year old company specializing in plumbing contracting. The second is Energy-Wise HVAC, a one year old contracting firm that performs heating and air conditioning work. My companies employed a half dozen people and gross half a million dollars annually. In addition, I am Past President of the Plumbing-Heating-Cooling Contractors of New Jersey and an incoming member of the Legislative Committee of the National Association of Plumbing-Heating-Cooling Contractors (NAPHCC).

The National Association of Plumbing-Heating-Cooling Contractors is the oldest national association in the construction industry and the largest in the plumbing-heating-cooling industry. It has 6000 members. Membership comes from every state in the country and is organized through about 300 state and local affiliated associations. This industry employes over 400,000 people and has receipts of over 21 billion dollars.

I am appearing today to express our opposition to S. 1174, the amendments to the Public Utility Holding Company Act (PUHCA), because of the adverse impact the legislation will have on us as small businessmen. We believe that this bill, as introduced, favors large business utilities over small businesses. Moreover, these are large businesses that are monopolies protected and guaranteed a profit. That profit is based on compulsory rates which consumers must pay.

PUHCA continues to prevent abuse

The PUHCA was originally enacted to curtail abuses which may be less likely to recur today. However, it has also grown to fill another purpose which may be more important today -- the preservation of free enterprise small business contractors. Revisions to the Act threaten to promote monopolization and encourage unfair and anticompetitive activities by utilities in competition with contractors.

Utilities are frequently large businesses who are guaranteed a profit by the state regulatory commissions. Our contractors are small businesses who compete vigorously to even make a profit.

With the increased attention being devoted to energy conservation, we already have seen a growth in utility activity in markets that have traditionally been the contractor's. Removing restrictions would encourage diversification into the markets of small business contractors. Utilities would be more free to devise strategies which enhance their strengths and to avoid the oversight of state public utility commissions. Even under existing law, utilities are reaching into our markets.

Utility rate structures provide for guaranteed profits or return on investment. Since the rate of return is set by the state regulatory commission, the utility must turn to increasing its investment which provides a larger rate base to enable it to increase profits. This, in turn, produces higher rates to the consumer.

The competition created by the utility may result in lower direct costs to the consumer in the short term. However, this hides the indirect costs for the consumer, the overhead and bureaucracy of the utility paid by all rate payers. Traditionally, once monopolization occurs, prices go up.

As recently as the beginning of the last decade, utilities were aggressively promoting energy consumption to enhance revenues and investment. With the onset of the energy crisis in the mid 70's, utilities sought new means to compensate for declining revenues. They settled on increased penetration of the energy conservation markets to encourage fuel switching and to lock consumers into their fuel type to gain new income.

Utilities already had some involvement in service work. These efforts are now extending to sales and installation as well. As utilities establish reputations for contracting services, they enhance their ability to branch out even further into areas which have traditionally been the realm of the contractor.

Removal of restrictions would encourage circumvention of other laws

Although the Securities and Exchange Commission supported repeal of PUHCA in their December 21, 1981 letter to you, Mr. Chairman, they also noted the effect which the Act has on competition by utilities. They note that while the Act only subjects 12 active holding companies to direct regulation, it "continues to have significant influence on the financing and diversification decisions of a much larger portion of the industry."

Quoting further, Chairman John Shad said, "Utilities may be reluctant to form holding companies because they would then have to register under the Act or qualify for an exemption."

The National Energy Conservation Policy Act (NECPA) prohibits utilities from sales, service and installation of energy conservation measures unless they were already involved in these activities prior to enactment. We have already seen many new initiatives to compete with contractors by those utilities that were grandfathered under NECPA to continue their current activities.

To remove the restrictions of PUHCA would encourage other utilities to escape the prohibition in NECPA by creating holding company arrangements. A utility that is prohibited from conducting certain supply and installation activities under NECPA could use its holding company (or create a holding company) to house a subsidiary to perform activities it would otherwise be prohibited from doing.

In addition, greater flexibility to create and use holding companies would create greater opportunities to circumvent oversight by state regulatory agencies. The authority to diversify up to 10% of assets would likewise even eliminate any review by the Securities and Exchange Commission.

Removal of restrictions would promote unfair anticompetitive behavior

Contractors and their mechanics are highly skilled and technically competent people. Normal requirements for plumbers are 4 years of classroom and on the job apprentice training to become a journeyman and up to 10 years as a journeyman to apply for a master plumber's license and work as a contractor. Two thirds of the states have licensing laws to insure the competency of plumbing contractors. Many of the remaining jurisdictions have local licensing laws. These requirements have been developed to protect the health and saftey of the consumer, yet many utilities do not operate under the same requirements.

More than 90% of the members of the National Association of Plumbing-Heating-Cooling Contractors are small businesses by standards set by the Small Business Administration. The median contractor nationwide grosses less than a million dollars annually and employes a dozen mechanics.

During the last few years, there has been a great deal of public attention to developig public policy that promotes the health and viability of small business. However, even the larger contractors are finding that they are no match to the vast array of resources available to utilities.

Let me cite some examples.

Utilities can hire marketing, publicity, economic and technical experts to develop messages to the consumer. They can target efforts at particular products. The small business contractor cannot afford the overhead to develop these sophisticated marketing tools.

They can negotiate favorable prices through bulk orders directly with manufacturers. A contractor purchases products for installation from his supply house who in turn obtains them from the manufacturers.

Utility companies have direct mail access (with postage paid for by the rate payer) into the homes of consumers via enclosures with regular utility bills. Small business contractors must cultivate every lead they get.

Utilities benefit from cross-subsidization by all rate payers, some of it mandated by statute to perform the Residential Conservation Service energy audits under NECPA. Small business contractors must collect all of their costs for a job from that customer. Certainly contractors are in no position to offer reoates as utilities have done.

Whether marketing through a subsidiary or directly, customer credit checks can be made readily by the utility by checking the payment record on utility bills. Such readily available credit checks are not as available to small business contractors.

Utilities frequently have financing programs at favorable interest rates for consumers. The consumer may be able to make payments on utility contracting measures over an extended period of time as part of the utility bill. Small business contractors seldom have the capital or cash flow to provide such financing arrangements.

When utilities or their subsidiaries expand or develop new promotional practices, risk plays a different role. If they loose money, they still have the rate base to fall back on. A small business contractor who seeks to expand or develop new markets may find it necessary to risk the whole company with no parent operations to fall back on.

By their very nature as publicly regulated businesses, utilities are monopolies that reach into most homes and businesses in the service area. Signs and markers designate the prescence of their facilities and remind us of their network. Every month, we see their bill come in. Every month, we are reminded of the name of the utility when we write our check. Thus, whether they sell, install or service equipment on their own or whether they do so through a subsidiary, they have an immediate advantage of name recognition before they even print their first advertisement.

In contrast, there are usually a number of contractors in an area. Although they compete vigorously, few have the capability to approach the name recognition of the utility because they do not have the same opportunities for comprehensive regular contact with consumers.

If the utility takes over this work, the injury is not only to the small business contractors, but also to the thousands of skilled mechanics they employ, and to consumers who will find they have less alternatives to choose from. Competition will have been eliminated.

Market disruption has already begun

The threshold for major market penetration has already been crossed. The risk of monopolization of the energy conservation market has probably never been greater. Utility involvement poses threats of major disruption of the market and to the structure of the contracting sector.

Sales of energy conservation products is one major area. Licensing requirements and other state and local regulations assure consumers of the integrity of contracting firms. Yet some utilities are apparently using only selected contractors for installation. The use of this practice institutionalizes a market allocation scheme.

If utilities emphasize the sale of equipment, leaving the installation to contractors, then the contracting industry looses its independent and competitive character and becomes beholden to them for business. The utility is able to determine prices and to enter the ranks of brokers of contracts. If the utilities pursue the installations as well, then many small business contractors will be left bankrupt in the trail of growing utility dominance.

Utilities have already made major inroads in the sale, installation and service of equipment which traditionally belonged to the contractor. As an appendix to my testimony, I have attached a number of examples of these intrusions into our markets.

In addition, contractors face even greater threat on the horizon. With the passage of the Energy Security Act in 1980, Congress created the Commercial and Apartment Conservation Service (CACS). Under this legislation and under proposed regulations from the Department of Energy to implement it, there are no protections whatsoever against anticompetitive activity. Once those regulations are finalized and utilities are required to provide energy auditing services to apartment buildings and small commercial enterprises, we expect to see a major increase in promotional practices in sales, service, and installation by the utility companies throughout this country.

In a recent survey of our membership, 45% already see sales and installation of gas fired appliances by utility companies. In addition, more than half of the contractors agree that utilities offer an unfair price advantage.

While we would hope that the state regulatory commissions would stem the tide of the utility growth, that has generally not been the case. As in Flordia and in New York, the commissions have focused on energy conservation and have not been concerned with looking at the competitive impact, particularly on small business.

As a result, the small business contractors who struggle to even make a profit are being forced to support their competitors, the large utilities who are guaranteed a profit. Support comes in the taxes consumers pay which support Department of Energy programs institutionalizing unfair competition. However, even more direct support is provided by the utility rate which consumers and contractors must pay which permits the utility to cross-subsidize.

Conclusion

Any revisions to PUHCA should go beyond an evaluation of the financing arrangements of utility company holding companies. The Congress should consider the anticompetitive effects unleashed on small businesses.

The Act provides protection which must be maintained. Loss of that protection will result in a significant loss of small businesses and major market disruption. We are at the threshold of those changes. Rather than promoting the demise of small business contractors, government action is mandatory to reverse the damage that has already been done.

Contractors are already facing increased utility competition in many parts of the country. Because of the competitive imbalance, such as cross subsidization, and the utilitys' monopoly control of resources, we believe that there already is a serious problem of unfair and anti-competitive activity by utilities covered by the Act. In addition, utilities not covered by the Act will seek cover under the loose provisions of these proposed amendments. Such unfair and anti-competitive behavior should be curtailed, not enhanced. Clearly, the state regulatory agencies should review the activities of utilities before they enter them, keeping in mind the competitive impact.

Thank you and I would be happy to answer any questions.

Appendix I

ALABAMA

Alabama Gas Company has announced plans to sell and install gas grills. Later, they plan to also provide water heaters, clothes dryers, ranges, space heaters and furnaces.

Estimated costs for the utility are:

Utility's selling price =		$340.00
minus warehousing	$25.84	
installation	85.00	
employee commission	15.00	
6% sales tax	14.44	
		141.28
		198.72 = utility's cost of the unit.

The cost of the same unit to a local contractor purchasing from the distributer is $218.72.

Contractors in the area are questioning not only the cost factors, but also the utility's marketing practices of providing every utility employee with a sales booklet to promote the grill and the utility's financing at 14%, both of which are alleged to be unfair and anticompetitive.

CALIFORNIA

San Diego Gas & Electric is conducting a ratepayer - subsidized solar rebate program. Rebates are available for homes which heat water by electricity or propane.

Southern California Gas Company of Los Angeles provides rebates to apartment owners who have combined solar/gas water heating systems.

Southern California Gas Company of Los Angeles also sells shower heads and water heater blankets while offering rebates on them from $5 to $21. Financing of improvements over $150 can be financed through the utility at 8%.

California Edison Company offers low interest 8% financing or cash rebates to electric customers who make improvements including heat pump water heaters, clock thermostats, replacement air conditions, insulation and other conservation improvements.

MASSACHUSETTS

Bay State Gas advertises that it rents the Energy Stretcher water heater for $8.50 a month which includes free installation and maintainance.

MISSOURI

Laclede Gas Company of St. Louis has entered into the service, repair, and installation of gas appliances for residential and commercial consumers. Utility programs include gas water heaters, space heaters, and gas bar-b-que pits, as well as insulation, insurance and security protection systems. Laclede offers one day loan approval at rates 2% less than Mastercharge. Advertising is sent with the bill and billing is done on the gas bill.

Area contractors note that while the average growth of successful service companies has been less than 40% in the last 5 years, the utility has almost doubled their service work and service personnel.

The Plumbing Contractors Association of Metropolitan St. Louis, Sheet Metal Contractors Association, and the Air Conditioning - Refrigeration Contractors have filed an intervention in the utility's rate increase request charging that the service work is being cross-subsidized by the rate payers.

NEVADA

Sierra Pacific Power Company, Reno, Nev., is featuring the White-Rodgers Comfort-Set clock thermostat in promotional mailings to its 170,000 gas and electric customers. The company invites customers to purchase items from its mail-order catalog of energy-saving products. Different products are featured from time to time on its monthly billing envelope.

OHIO

East Ohio Gas Company offers free water heaters to encourage consumers to hook up to their gas lines.

Cincinnati Gas & Electric (CG & E) of Cincinnati is installing free "curb boxes" and checks for gas leaks at the same time. When they find a leak, they offer to repair it for $75.00. Alternatively, they suggest to the consumer that he can call his plumber, but the plumber will have to pay CG & E $75.00 for permits in addition to charging for time and materials.

OKLAHOMA

Public Service Company of Oklahoma has been sued by 4 outdoor lighting companies for monopolizing business in the area by furnishing services below cost. The 4 companies charged that the utility has abused its public utility status by installing and maintaining outdoor lighting on private property while refusing or stalling on their request for hookups for their own lighting installations.

The utility denied it supplied its services below cost. It also argued that as a state-regulated entity, it was exempt from federal antitrust statutes.

A federal district court upheld the utility on the ground that there was no evidence that interstate commerce had been adversely affected. However, the U.S. Court of Appeals said tne companies only had to show that interstate commerce was affected. The appellate court has ordered a retrial of the antitrust suit.

TENNESSEE

Chattanooga Electric Power Board which is owned by the city of Chattanooga, TN is selling, and installing electric water heaters, heat pumps and cooling units. Contractors in the area charge that the utility does not have the proper licenses to install the equipment.

WASHINGTON

The Public Utility District #1 in the Seattle area provides free water heater blankets and offers energy audit services under the Residential Coservation Service.

Washington Natural Gas is an investor owned utility that promotes product sales on their utility billing envelope. Included are attic and wall insulation, fireplace inserts, vent dampers, gas water heaters, gas ranges, gas furnaces, washers and dryers, gas wall heaters, automatic thermostats, AID kits, solar pool equipment, solar water heating, commercial products and other.

WISCONSIN

Madison Power and Light has begun advertising for energy efficiency engineers to conduct Commercial and Apartment Conservation Service work.

Senator D'AMATO. Thank you, Mr. Farruggia.

Mr. Sapio.

STATEMENT OF AL SAPIO, PRESIDENT, ARLAND DAMPER CORP., BEHOEMIA, N.Y., ON BEHALF OF THE SHEET METAL & AIR CONDITIONING CONTRACTORS NATIONAL ASSOCIATION

Mr. SAPIO. Mr. Chairman, members of the subcommittee. Thank you for inviting me to appear before you today to testify on S.1174, "The Public Utility Holding Company Act Amendments of 1983."

My name is Al Sapio. I am the President of the Arlan Damper Corporation, a sheet metal firm located in Bohemia, New York. I am a member of the Sheet Metal and Air Conditioning Contractors' National Association—SMACNA— and President of the Long Island chapter. SMACNA is a working participant in the Alliance for Fair Competition, represented by this panel.

SMACNA is a national trade association representing some 2,400 union construction contractors involved in the fabrication and installation of heating, ventilation, air conditioning and energy conservation systems. Our members are small businessmen. It is as a small businessman that I appear before you today to offer SMACNA's concerns about this proposed legislation.

I urge this subcommittee to closely examine the problems of small business contractors who may be—and in some cases already have been—put at a competitive disadvantage by potentially unfair practices of public utilities in their diversification processes. Small business has survived by learning to work in a competitive environment. We do not want to limit competition, but merely make it fair for all competitors. A small businessman cannot compete with some of the inherent advantages of a public utility—its name recognition, its access to customer lists and marketing devices and its access to capital—if that public utility uses these advantages in its new venture. We are concerned that these amendments would make this occurrence more likely.

Mr. Chairman, as a example, I point specifically to a situation you and I are both very familiar with—LILCO. In 1981, LILCO proposed loaning $1 million to a wholly owned subsidiary, LILCO Energy Systems, which would supply and install energy conservation equipment. This is the mainstay of many Long Island SMACNA contractors. LILCO then invested $200,000 in the subsidiary. A petition was filed with the Public Service Commission on behalf of several contractor groups on Long Island, requestion that the PSC deny LILCO's request to establish the subsidiary due to the anticompetitive practices being used to accomplish that. Although LILCO was eventually refused permission to develop LILCO Energy System, the PSC refused to consider competition as a factor in its decision. This despite the fact that LILCO Energy Systems would have benefited form LILCO's name identification, customer lists, direct mail ability and LILCO's financial backing.

Will the LILCO situation arise again? It may resurface on Long Island. Similar situations have already occured in other parts of the Country. SMACMA has received complaints from contractors from New York to Wisconsin to New Mexico to Oregon.

We feel strongly that there must be a check on the process—to make sure that the competition is fair. To guarantee that competition is a major consideration. And to make sure that unfair and anticompetitive practices do not make their way into the system. Give us equal opportunities and I would be proud to compete.

Thank you again for this opportunity to testify. We will be submitting a more detailed statement, which I request be added to the record. SMACNA stands ready to assist you in any way in your search for a solution to this problem.

Mr. Levin. Thank you, Mr. Sapio.

[The complete statement follows:]

The Sheet Metal and Air Conditioning Contractors' National Association, Inc.

SMACNA

TESTIMONY OF AL SAPIO

BEFORE SECURITIES SUBCOMMITTEE OF

SENATE COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

JUNE 14, 1983

S.1174

"PUBLIC UTILITY HOLDING COMPANY

ACT AMENDMENTS OF 1983"

SMACNA is a National Trade Association representing some 2500 sheet metal contractors engaged in the fields of heating, air conditioning, air pollution control, solar energy installation, architectural sheet metal and other metal applications. The sheet metal contracting industry totals over $8.6 billion annually.

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Testimony before the Securities Subcommittee
of the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman. Members of the Subcommittee. Thank you for inviting me to appear before you today to testify on S.1174, "The Public Utility Holding Company Act Amendments of 1983."

My name is Al Sapio. I am the President of the Arlan Damper Corporation, a sheet metal firm located in Bohemia, New York. I am a member of the Sheet Metal and Air Conditioning Contractors' National Association -- SMACNA -- and President of the Long Island Chapter. SMACNA is a working participant in the Alliance for Fair Competition, represented by this panel.

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I urge this subcommittee to closely examine the problems of small business contractors who may be -- and in some cases already have been -- put at a competitive disadvantage by potentially unfair practices of public utilities in their diversification processes. Small business has survived by learning to work in a competitive environment. We do not want to limit competition, but merely make it fair for all competitors. A small businessman cannot compete with some of the inherent advantages of a public utility -- its name recognition, its access to customer lists and marketing devices and its access to capital -- if that public utility uses these advantages in its new venture. We are concerned that these amendments would make this occurrence more likely.

SMACNA's concerns with unfair competition from public utilities began in the late 1970's as utilities moved away from strictly supplying energy to installing and servicing energy systems. Legislatively it began with the passage of the National Energy Conservation Policy Act (P.L. 95-619) and the Energy Security Act (P.L. 96-294). These laws mandated the Department of Energy to establish the Residential Conservation Service (RCS) and the Commercial and Apartment Conservation Service (CACS) programs. Both were designed to "encourage the use of energy conservation and renewable resource measures" and required public utility companies to conduct energy audits.

While RCS mandated that utilities maintain a list of approved contractors who could handle the work found necessary by the energy audit, CACS did not limit the work which could be done by public utilities following the required energy audit. These energy audits led some public utilities into the sale and installation of energy conservation equipment such as heat pumps, more efficient water heaters and furnaces, etc.

Let me state categorically that SMACNA does not oppose the principles of RCS and CACS. Energy conservation and the education of Americans as to the significance of energy conservation is in the public interest. And it's good for our business. However, the consequences -- probably unintended -- of these programs has been to put the small businessman at a competitive disadvantage as public utilities diversify into areas traditionally held by private contractors.

These hearings are being held on proposed amendments to PUHCA. They are not oversight hearings on RCS and CACS. However, I do feel it is important that the record show the origin of the problem of competition, which can now be dealt with in this setting.

RCS and CACS programs began the entry of public utilities into our industry and it has grown over the past several years. I will describe several examples of problems. Each of these problems has been reported to SMACNA's national office by various chapters around the country. Although I will only briefly mention three problems, SMACNA has received complaints from contractors around the country. Some complaints point our ongoing practices of utilities. Others point to dangerous omens of things to come. We are fighting not only problems, but are attempting to put our finger in the dike before more leaks occur.

Mr. Chairman, I point first to a situation you and I are both very familiar with -- the Long Island Lighting Company (LILCO). In 1981, LILCO proposed loaning $1,000,000 to a wholly owned subsidiary, LILCO Energy Systems, which would supply and install energy conservation equipment. This is the mainstay of many Long Island SMACNA contractors. LILCO then invested $200,000 in the subsidiary. A petition was filed with the Public Service Commission (PSC) on behalf of several contractor groups on Long Island, requesting that the PSC deny LILCO's request to establish the subsidiary due to the anti-competitive practices being used to accomplish that. Although LILCO was eventually refused permission to develop LILCO Energy Systems, the PSC refused to consider competition as a factor in its decision. This, despite the fact that LILCO Energy Systems would have benefitted from LILCO's name identification, customer lists, direct mail ability and LILCO's financial backing.

Another example was presented by SMACNA's New Mexico chapter, headquartered in Albuquerque. Members of New Mexico SMACNA have been active in a coalition entitled, "Ratepayers United." Members of the coalition are not just small businessmen who are concerned about the anti-competitive practices of utility diversification on their businesses, but are also ratepayers who are concerned that the utilities' diversification will adversely effect the rate base of the utility. Ratepayers United was established to seek state legislative and administrative relief for the problem of unchecked utility competition, specifically by the Public Service Company of New Mexico, which has already diversified its business to include land development, ranching, and owning and operating a fiberboard plant, a helicopter service and an HVAC (heating, ventilation and air conditioning) service company. It is, of course, the last of these that directly effects SMACNA contractors, although the other businesses listed will effect the competitive nature of other New Mexico industries.

Ratepayers United was instrumental in convincing the state legislature to place an 18 month moratorium on utility diversification. The purpose was "to allow time to study whether such expansion would benefit New Mexico's economy." The moratorium will be lifted in August after the Legislature agreed not to continue its actions. Effectively the state has given its approval to utility diversification. The Public Service Company has announced it is studying new ventures into diversification, which will take place immediately after the moratorium is lifted.

Lastly, I will mention the problem encountered in Wisconsin by SMACNA contractors. Wisconsin Power and Light (WP&L) initiated a program to offer a furnace service and maintenance plan for an annual fee of $59.95 by mailing promotional flyers to all WP&L customers. This payment was to cover a complete furnace check, the cost of all parts and labor needed to repair the furnace and 24-hour emergency service for a year. Contractors in the service area of WP&L were already offering the same program to customers -- although prices were $25 to $30 higher than quoted by the utility. Jointly, local chapters of SMACNA, the Mechanical Contractors of America and the Association of Plumbing, Heating and Cooling Contractors requested data from WP&L to determine how the utility could undercut private contractors' prices and still cover all costs of their program. The data was not supplied.

These associations have continued to pursue the problem of utility competition in Wisconsin, and have already spent over $50,000 in the effort. Representatives have appeared before the Public Service Commission, the Bureau of Competition of the Federal Trade Commission and the state legislature. These trade associations have been joined in their efforts by the Madison Building and Construction Trades Council.

Dick Ross, past President of the Madison Chapter of SMACNA, has stated the concern succintly:

"I think it's a very dangerous situation when a public utility is in competition with private enterprise. I really wouldn't have as much problem with it if they had to play under the same rules we do..."

We feel that these proposed amendments to PUHCA would encourage public utilities to further increase their diversification into our industry while removing some of the checks on this process that now exist in the system. Presently, if a utility forms a direct subsidiary, the activities of the utility and its subsidiary are governed by state public service commissions. One way to circumvent this state regulation is for a utility to form a holding company and then diversify by creating a subsidiary of the holding company rather than of the utility itself. The creation of the holding company by utilities can then be used to escape regulation by the state public service commissions. However, by so doing, the holding company and its activities come under the regulatory umbrella of the federal government and the SEC as defined in PUHCA.

Plans for diversification by holding companies must be approved by the SEC. In the past, under PUHCA as it presently stands, the SEC has limited diversification to some extent and, in so doing, has discouraged widespread use of the holding company structure. This is not to say we are satisfied with the current PUHCA. We feel strongly that the language of the law must reflect Congress' concern with small business and competition. The lack of any language of this kind has had unfortunate consequences, as evidenced by the LILCO problem. Competition, it was decided, was not relevant. We say it is relevant and it is in the public interest.

Proposed PUHCA amendments would worsen the situation as it would place a high threshold on allowable diversification without SEC approval being needed. Whatever restraints were put on diversification before would be severely lessened. Rather than giving utilities the opportunity to diversify without oversight, I propose that public notices and hearings be scheduled on diversification. Let concerns and complaints be aired before it is too late. If the utility is justified in its actions and diversification is good for the utility, the economy, the ratepayers and the market, diversification will take place. The utilities lose nothing. However, if the proposed diversification introduces anti-competitive practices to the marketplace, those potentially effected deserve the right to air their concerns.

In summary, let me state that SMACNA is extremely concerned about the proposed legislation being discussed today. Our national staff stands ready to assist you in your search for an equitable and fair solution. As you know, we are already in discussion with representatives of utilities. These discussions will continue.

SMACNA asks this Subcommittee to consider three proposals:

1) That a provision be included which would recognize the validity of the potential of anti-competitive practices and that therefore, this should be a factor in diversification decisions.

2) That a system be established which would allow for public airing of diversification plans and concerns of all potentially effected parties.

3) That a system of redress be established so when competition does become a problem, there is an avenue for correction of the problem. Thank you for this opportunity to testify.

Mr. LEVIN. Thank you, Mr. Sapio.

CASES OF CROSS-SUBSIDIZATION

Mr. Farruggia, you cited certain cases of cross-subsidization. My question is, did you ever call this to the attention of the State regulators?

Mr. FARRUGGIA. In my prepared statement there are instances of where it has been found and where it has been beaten back. I believe one such case would be in Idaho where they were going into the service business. I'm not sure of which particular gas or electric company it is, but they were going into the service business and they tried to say that they were not cross-subsidizing. It was proven that they were working out of the same office. They claimed that it was an arm's length relationship, but then it was found that they were using the utility company trucks to do the service work with utility company employees. They had to cease and desist because they couldn't prove that they were holding it at arm's length at that point.

There are other instances that I'm not completely familiar with.

Senator D'AMATO. Does the Justice Department have the ability to prevent these anticompetitive practices from taking place and do any State utility regulatory authorities have the jurisdiction to stop the practices that you have testified about?

Mr. FARRUGGIA. From what I understand, the State regulatory authorities may have jurisdiction. Apparently not all States have these authorities and have this jurisdiction. From what I understand there is a very small minority of States that do have these, shall we say, regulations in place.

Senator D'AMATO. Are these practices taking place at the present time?

Mr. FARRUGGIA. They are being investigated right now in New Jersey. The one instance that I brought up as you came into the room is probably not more than 2 years old in Idaho.

Senator D'AMATO. My point is that S. 1174 has not created the problem. Thus it becomes a question of how do we deal with that problem? Do any of you gentlemen have suggestions or thoughts in terms of dealing with the problem that exists now?

Mr. FARRUGGIA. I would say that——

Senator D'AMATO. By the way, we're going to ask the utility people when they testify to address that point because it's a very valid point. Please continue.

Mr. FARRUGGIA. I know our national association staff has been in negotiations, shall we say, with certain utilities and with possibly this committee from what I understand.

Senator D'AMATO. They have been dealing with the staff, but you're the fellow out on the firing line, so to speak, and you understand the nature of the problem and those practices that are injurious to your business: It is important to state at this time that the committee is very interested in how these practices affect the consumers, too. Therefore please state not only your concerns but also what you would consider to be legitimate avenues to protect the consumer because in the final analysis that's what we're doing.

Also, what I need to know from you gentlemen is whether or not you would be happy if we were to drop S. 1174?

Mr. BURDETTE. No, sir.

Mr. FARRUGGIA. I think we all agree that it does need changes.

Senator D'AMATO. Good, because I don't think that that's going to answer the problem that exists at the present time. I think that this legislation might be the framework in which we can narrow our differences and maybe even come up with legislation and legislative language which you could support because it will improve the position of the small businessman.

Mr. SAPIO. Senator, what I think we see, we would be in favor of your proposed amendments with regard to the unfair practices, but I think what we would like to see is at the State level with the PSC a mandatory review prior to the utilities establishing these subsidiaries with public hearings.

We believe that with public hearings the merit of the diversification will stand on its own. If it winds up being anti-competitive, it will be determined through the hearings. We are not asking for a carte blanche determination that there will be no diversification. There are areas such as cogeneration where it's worthwhile.

Senator D'AMATO. So you're suggesting that giving the State regulatory authorities, the PSC's, et cetera., ability to rule on diversifications might be one way to satisfy your concerns.

Mr. SAPIO. Right.

Senator D'AMATO. All right. Now I'm not looking for any binding commitment from you. We're just exploring some thoughts and ideas here. Does anybody else have anything else to add in this regard because it seems to me that's your issue? If I'm wrong, if I'm missing something, please tell me.

IMPACT ON THE CONSTRUCTION INDUSTRY

Mr. BURDETTE. I'd like to express our concern over the competitive nature as it relates to the construction industry.

We're concerned in our experience with SEI and the other subsidiaries of the Southern Co. This particular company, SEI, is merely a broker. They aren't going to handle construction contracts. They merely bid the job. They have no personnel or equipment. They will, in turn, in effect subcontract this work out to the various system outlets, Georgia Power and Alabama Power, and whoever. They will subcontract this work to them or they, the other subsidiaries, will accept these subcontracts at no cost.

I, as a contractor, cannot go out and hire subcontractors willing to work at no cost. That's certainly an advantage to them and it really limits the competition being able to do that.

Senator D'AMATO. Senator Sarbanes has just joined us. Senator, do you have any comments or any questions that you'd like to put to this panel? This is a panel that I might fairly describe as contractors, small business people, who are concerned not only about S. 1174 but also about what they perceive to be the anticompetitive practices by the utilities. Mr. Burdette was just giving an illustration of that whereby contracting work is given to a subsidiary who with literally no cost factor attached to it or no profit.

Mr. **Burdette**. In fact, it could even be at a loss for all we ever know. In case of such loss, it would be underwritten or subsidized by the ratepayers, which is another concern of ours.

Senator **D'Amato**. Well, as the Chair has indicated several times we are concerned about that and are looking for some suggestions on how to deal with the present problems of tie-ins. The Small Business Committee may be holding hearings, and possibly the Small Business Committee might be able to focus on the ability of the Small Business Administration, the Justice Department or the Federal Trade Commission to deal with anti-competitive practices. I don't think it's appropriate for the SEC.

Senator Sarbanes, do you have any questions at this time?

Senator **Sarbanes**. No. I only want to say, Mr. Chairman, that I think the testimony of this panel, which I had a chance to look through, is very helpful. It underscores the complex nature of the issue that we're dealing with and the fact that it has a number of dimensions which need to be very carefully addressed. I think perhaps there's been an assumption on the part of some that there aren't as many, or perhaps as far-reaching consequences as some of this testimony indicates there may well be. The possibility that there's going to be competition under two different sets of rules, as far as the parties that are involved are concerned, and in terms of their ability to carry it out, is something which needs to be very carefully addressed. You all have underscored that in your testimony, not only with respect to the future but even as to some things that are happening now. That's been very helpful.

Senator **D'Amato**. We thank you very much for your testimony and we look forward to continuing dialog to see if we can address some of the problems that are now before you. Thank you very much.

I now call our third panel. Gentlemen, thank you very much to agreeing to testify today. Since we are running late we ask you if you could summarize your testimony. I think we've made a lot of progress in terms of where we have come from last year to this year. You all testified last year, so why don't we start with Mr. Jackson.

STATEMENT OF ELMER J. JACKSON, SENIOR VICE PRESIDENT, GENERAL COUNSEL, AND SECRETARY, KN ENERGY, INC., LAKEWOOD, COLO.

Mr. **Jackson**. Mr. Chairman and members of the Subcommittee on Securities, I am Elmer J. Jackson, senior vice president, general counsel and secretary of KN Energy, Inc. ("KN"). I am pleased to have this opportunity to testify on S. 1174, the Public Utility Holding Company Act Amendments of 1983.

To put KN's testimony in perspective, I will first provide a brief description of the company and its operations and then explain our views on S. 1174.

KN provides natural gas service at retail and wholesale to industrial, agricultural, commercial, and residential customers principally in Colorado, Kansas, Nebraska, and Wyoming, and thus is a public utility as defined in the Holding Company Act. Through subsidiaries we also engage in various nonutility businesses, including oil and gas exploration and production, and coal and uranium exploration and development. To reflect the broad nature of KN's business as a diversified energy company, we recently changed our corporate name from Kansas-Nebraska Natural Gas Co., Inc. to KN Energy, Inc.

Multiple State and Federal agencies oversee our diverse activities. At the Federal level, KN is subject to the jurisdiction of the Securities and Exchange Commission and the Federal Energy Regulatory Commission. At the State level, as to rates and service we are regulated by the Colorado Public Utilities Commission, and as to rates, service, and issuance of securities we are under the jurisdiction of the Kansas State Corporation Commission and the Wyoming Public Service Commission.

Mr. Chairman, KN is not a holding company or a subsidiary of a holding company and therefore it is not subject to the regulatory provisions of the act. For this practical reason, we cannot speak from experience or with authority about most of the provisions of S. 1174 that would amend various regulatory provisions of the act. Except to express our concurrence as to the general desirability of relaxing or eliminating provisions that may have outlived their usefulness or become inappropriate in today's changed circumstances, my testimony will concentrate on the subject of diversification and the provisions of S. 1174 bearing on that subject.

Mr. Chairman, KN generally supports the approach contained in S. 1174 to the subject of diversification by public utility companies or holding companies with public utility subsidiaries. In our view, the bill would permit modest and measured diversification undertaken by such companies within the framework of the Holding Company Act without sacrificing the important public interests which the act was intended to safeguard in recognition of the special status of public utilities.

Conversely, KN is staunchly opposed to the repeal of the statute. For nearly 50 years, the Holding Company Act has served as a barrier against takeovers of a utility company or permissible holding company by a remotely located, non-public-utility-oriented enterprise or conglomerate.[1] History demonstrates the dangers of diversification superimposed on a public utility by a company headquartered far away and engaged predominantly in other businesses. It is insufficiently concerned with public utility obligations. The public utility is lifely to become just another prize to be captured and added to the stable. If so, it must be assumed that management policies and priorities will be set accordingly and that State regulation and local managerial control of the public utility, as such, will often be frustrated.

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[1] Appendix 1 to this statement contains and excerpt from Volume 73-A (the summary and conclusion volums) of the Federal Trade Commission Report, providing a brief catalogue of some of the major types of abuses that had been found prior to 1935. Appendix 2 is the text of Congress's 1935 findings (in Section 1 of the Act) about abuses facilitated by holding company structures and the need for legislation to protect investors, consumers, and the public interest. Appendix 3 consists of excerpts from a 1938 article by then SEC Chairman, later Supreme Court Justice, William O. Douglas, emphasizing the local or regional character of electric and gas utilities and the abuses associated with financially-oriented remotely-located and managed holding companies. Appendix 4 contains excerpts from the opening pages of testimony before the Securities Subcommittee of the House Committee on Interstate and Foreign Commerce in 1946 by the SEC Chairman Ganson Purcell, in which he summarized the original reasons for the Act, what has been accomplished under the Act, and why, as of that date, the Act should remain unamended.

Under present market and credit conditions, in which billion dollar, hostile takeover contests are commonplace, it is not difficult to imagine a situation in which an acquisitive entrepreneur or promoter might seek control of a public utility because of capitive business opportunities, leveraging possibilities, real estate holdings with development potential, diversified energy activities, or for other reasons. These are not theoretical concerns. KN itself is now vigorously resisting, in Federal district court proceedings, an apparent takeover effort by a nonutility group.

Mr. Chairman, we believe the provisions of the bill relating to diversification undertaken by a pubic utility or public utility holding company would provide proper and reasonable latitude without adversely affecting the interests of investors or consumers or effective State regulation. KN can attest to the value of diversification. As stated above, we are not subject to the provisions of the act that limit diversification into nonutility business (section 9(a)(1)). The latitude to pursue promising business opportunities consistent with our obligations as a public utility has been a positive and profitable experience for our shareholders as well as for the consumers and communities we service. And through our diversified activities, alone and in alliance with others, we are doing our share to achieve the national goal of energy independence.

The primary purpose of my appearance this morning is to express KN's strong support for section 8 of the bill which would address diversification of a different kind—that is, diversification into the public utility business by nonutility companies—and the administrative procedures attendant to the creation and registration of new holding companies. This section of the bill would reinforce the recognition in the original law of the special status and responsibilities of public utilities. Because of their unique characteristics, public utilities should not be the easy targets of predatory financiers and promoters. Section 8 of the bill would extend this basic premise of the act to remove any doubt that financial profiteering or empire building in public utility stocks and subordination of public utility obligations are no more acceptable or desirable today than they were 50 years ago.

Mr. Chairman, the Holding Company Act was the first anticonglomerate statute applied to electric and gas utilities. It has fostered localized management and removed impediments to effectuate State or local regulation of the Nation's gas and electric utilities. As stated earlier, it continues to serve as a barrier to the recreation of the worst kinds of holding companies and the reappearance of the abusive and scandalous practices that necessitated stringent regulation of utility holding companies in the first place.

Present section 9(a)(2) of the act was designed to prevent the creation of new holding companies except in strict compliance with applicable statutory standards and subject to prior scrutiny and approval by the Securities and Exchange Commission. Thus, the section now prohibits the acquisition of 5 percent or more of the voting securities of a public utility without prior SEC approval if the offeror already owns 5 percent or more of a public utility or if the target enterprise is comprised of two or more public utilities.

Of course, acquisition of more than 10 percent of the voting securities of even one public utility makes the acquiring company a holding company that must register unless an exemption is available.

The purpose of requiring advance review and approval of the acquisition of the securities of a public utility is to enable the Commission to assure compliance with the geographic integration, corporate simplification, and other public interest requirements of section 11 of the act. The Senate report accompanying the original bill described section 11 as the "very heart of the title" (S. Rep. No. 621, 74th Cong., 1st Sess. at 11 (1935)). Section 10 of the act is linked to section 11 and requires the SEC to approve only those acquisitions which "tend toward the economic and efficient development of an integrated public utility system" which effectuates the purposes of section 11.

Section 8 of the bill would close an anomalous gap in the administration of section 9. Under present law, a company may acquire 5 percent or more of the voting stock of one public utility without prior SEC approval. This has been termed a free "first bite". In several instances, where only a "first bite" had been taken without requiring the SEC to institute the review and approval procedures required by section 9(a)(2), the ultimate effect of later applying the statutory provisions—most notably section 11—was to require the Commission to order the newly created entity to be taken apart, at great cost and detriment to all concerned. The following illustrations underscore the burden the present law imposes on the Commission as well as the dangers it poses for public utilities, their shareholders, consumers, and State regulators:

> After acquiring a majority of the voting shares of a gas utility company without SEC approval, the buyer applied to the Commission for registration as a holding company. After registration was effected, the SEC ordered a Section 11 integration and simplification proceeding. Eventually, the SEC ordered separation of the gas utility and related business from the unrelated business. The company elected to divest the gas utility. (In the Matter of Penzoil Company, 43 SEC 709 (1968).)
>
> After acquisition of a gas utility company by a non-utility without SEC approval, application was made for exemption from the Act. The Commission did not issue the requested order. Following two years of negotiations, the applicant notified the SEC of its intent to dispose of the gas utility in order to avoid registration under the Act. (In the Matter of Lykes Bros., Inc., 46 SEC 1196 (1978), 46 SEC 1284 (1978)).
>
> The final illustration involved our own company. After acquiring almost 20 percent of our stock through a tender offer, the buyer attempted to force a merger. Both the acquisition and merger were opposed by K N. The acquirer asked the SEC to declare it not a holding company. Eventually, the SEC granted the application but imposed conditions designed to prevent any controlling influence on the part of the acquiring concern and to require advance notification of various types of transactions. The SEC's conditional order specifically noted the "[A] merger . . . would raise problems of compliance with the integration and capital structure standards of Section 11" and recognized the likelihood of forced divestitures in a Section 11 proceeding. (In the Matter of Kaneb Pipe Line Service Company, 43 SEC 976 (1968)).

In each of these cases, the potential existed for the SEC to order massive corporate restructuring and divestiture programs under section 11, including the possible divestiture of the public utility, after the acquisition had occurred. When each of these cased had run its course, it became clear that the respective utility companies and their investors and consumers had been subjected to disruptions, uncertainties, and great burdens of effort and expense, and that the respective acquiring companies and the Commission itself had likewise incurred burdens of effort and expense, that would have been largely avoided if the Commission had been authorized to consider the potential application of section 11 before the initial acquisitions were consummated.

In recognition of this defect in the Holding Company Act, S.1174 would eliminate the first "free bite". Proposed section 9(a)(3) would confer jurisdiction on the SEC to review the acquisition creating the holding company relationship in the first place. This will avoid the undersirable result possible under present law that allows an unregulated first acquisition to result in a substantial reorganization that would not have been necessary if the Commission had an earlier opportunity to determine whether the acquisition is in compliance with section 11.

Mr. Chairman, section 8 of S. 1174 would recognize and confirm the special responsibilities of public utilities and the State and local interest in regulating public utility ownership and control. The basic nature of electric and gas distribution companies has not changed since 1935. By definition, they are public utilities. They ordinarily operate as monopolies in their particular territories, and they are traditionally regarded as being vested with a public interest. It is accepted wisdom that, for such public utilities, State or local regulation substitutes for competition as the best means of assuring reasonable service at reasonable cost.

Section 10(f) of the act has always required the SEC to assure that the acquisition of the securities of a public utility or holding company complies with applicable State law prior to giving its approval. In this important respect, section 8 of the bill would reaffirm that close relationship between the Commission and State utility regulators and the constructive interaction between State and Federal Law concerning public utilities and holding companies. By allowing the SEC an earlier opportunity to scrutinize the proposed acquisition which triggers the Holding Company Act, section 8 of the bill would allow for the orderly reconciliation of the State and Federal interests underlying sections 9, 10, and 11 of the Holding Company Act.

This provision of S. 1174 draws authoritative support from the Federal Securities Code of the American Law Institute. The code added a clause to the analog to section 9(a)(2) to confer jurisdiction on the Commission to review the "first bite". The code was drafted in consultation with the SEC staff and with lawyers practicing under the act. In addition, not only the staff but the Commission itself, both under former Chairman Williams and under present Chairman Shad, have officially supported adoption of the code as a replacement for all of the statutes administered by the Commission [with certain modifications, but not of this particular provision]. We believe the Commission's earlier support for the strengthening of the present section 9(a)(2) in the manner contained in section 8 of S. 1174 is sound, notwithstanding the Commission's more recent recommendation for repeal of the act.

In summary, we oppose the repeal of the act. We support the provisions of S. 1174 which would allow greater freedom for registerd or exempt holding companies to diversify. We also support the general effort to review and revise other regulatory provisions of the act where appropriate in light of changed circumstances since 1935, but we express no opinion as to the merits of the specific provisions, other than as to diversification. We strongly favor the adoption of proposed section 9(a)(3).

We appreciate this opportunity to testify before you and hope that we have been helpful to the subcommittee in your revisiting of this important area of public policy.

[Response to written questions of Senator D'Amato and appendixes follow:]

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July 12, 1983

The Honorable Alfonse M. D'Amato
Chairman, Subcommitte on Securities
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

I have received your letter of June 21 requesting additional information with respect to my testimony presented to your Subcommittee on June 14. The questions asked and my responses thereto are as follows:

1. IF K N BELIEVES IN DOWNWARD OR SIDEWARD DIVERSIFICATION, WHY DO YOU OPPOSE DIVERSIFICATION RESULTING FROM THE ACQUISITION OF A UTILITY COMPANY BY A CONGLOMERATE OR OTHER NON-UTILITY COMPANY?

In my prepared statement, particularly at pp. 2-3 and pp. 5-6, I attempted to explain the distinction between the two types of diversification, and why we believe that the law should permit the former within reasonable bounds but should preclude or very strictly control the latter. In response to your question I will elaborate a bit further on what I said on this subject in my prepared statement.

The critical point to bear in mind is that a public utility, by hypothesis, is a company "vested with a public interest." Its management must be sensitive to the special public obligations of a public utility company, beyond those applicable to the ordinary business corporation. Since an electric or gas distribution company ordinarily operates as a monopoly in the territory that it serves, governmental regulation, rather than competition, is the necessary means of assuring that consumers get good service at reasonable cost.

A utility company (including one that, like K N, operates on an integrated basis in several contiguous states) is typically managed and regulated from within the territory in which it operates. It not only is a public utility, by reason of its exclusive franchise within its territory, but is also basically a localized enterprise, aware of and responsive to local needs and interests. Any diversification undertaken by it is necessarily limited by its paramount character as a locally managed and locally regulated public utility.

On the other hand, these inherent restraints tend to be lost when controlling management is remote from the local scene and from the likelihood of continuous and effective contact with local regulators. Still more is lost if the parent company is primarily engaged in non-utility enterprises, so that it considers the utility as just another profit center.

In short, the character of a public utility as an effectively regulated monopoly enterprise can be preserved where the utility, under localized control and regulation, diversifies downward or sideward. But that character is likely to disappear or be submerged if "diversification" takes the form of a remote, non-utility enterprise superimposing itself on the public utility company. This basically underlies our belief that, from the point of view of public policy, diversification undertaken by a public utility is altogether different from diversification superimposed on a public utility from outside.

In my prepared statement I mentioned an attempted takeover of our company by a company referred to as Kaneb. At the time (1967), as now, we operated as a gas utility company primarily in Kansas and Nebraska. Kaneb, a much smaller company, operated primarily as a common carrier of liquid petroleum products, via a pipeline running through several States in the Midwest including Kansas and Nebraska. Kaneb had been organized by a closely-held company known as Pipetech. The latter was in the business of rendering consulting, management and engineering services to the oil and gas industry in this country and foreign countries. It had entered into a management contract with Kaneb under which -- at a profit -- it supplied Kaneb's management and rendered various types of services on a continuous basis. It also performed engineering services for Kaneb from time to time on a project basis. The headquarters of Kaneb and Pipetech were located in the same suite of offices in Houston, Texas, outside of and remote from our company's utility service area.

If we had not successfully intervened before the SEC, invoking the Public Utility Holding Company Act, our utility operation in Kansas and Nebraska might have been forced to merge into an enterprise engaged in unrelated businesses in faraway places. The capital structure of the merged company would have been highly leveraged and complicated. Management and control would have been lodged in a group of individuals headquarterd in Houston, through the medium of a lucrative management and service contract between the merged company and Pipetech, similar to the Kaneb-Pipetech contract. We felt at the time, and still feel, that the end result would have reflected at least three of the most serious abuses at which the Holding Company Act was directed: (1) excessively leveraged and complicated capital structures, (2) siphoning of utility earnings to controlling persons by means of excessive service fees ranking ahead of interest or dividends on publicly-held securities, and (3) impairment of local regulation and localized management of utility companies.

In my prepared statement I also mentioned that our company was engaged in litigation to resist an apparent takeover effort by a non-utility group. This litigation arose out of the filing with the SEC of a Schedule 13D by a group of six corporations and individuals that owned in the aggregate over 8 percent of our common stock. In a decision handed down on June 30, 1983, Chief Judge Finesilver of the United States District Court for the District of Colorado held that the true purpose of the group, not adequately disclosed in the Schedule 13D, was to influence the management and policies of our company. The Court also pointed out that, in light of that purpose, the six persons might be found by the SEC to be a holding company under the Holding Company Act and subject to the obligations, duties and liabilities under that Act. (They would, of course, become a holding company of K N in any event if they, or any larger group of which they might be a part, attained aggregate holdings of 10 percent or more of our outstanding voting securities.) The Court held that the Schedule 13D did not include sufficient information with regard to the consequences of holding company status on the operations of our company.

The persons filing the Schedule 13D include a publicly-held company (Gulf Interstate Company) headquartered in Houston and involved primarily in providing pipeline engineering and consulting services and in oil and gas exploration; a privately-held firm headquartered in Columbus, Ohio, involved in oil and gas exploration; a publicly-held British investment trust; a London-based Austrian and Syrian citizen who maintains an international portfolio of investments, primarily in energy; that individual's controlled company; and an investment banker resident in New York.

None of the members of the group is a public utility nor is any of them located in any area served by us. Moreover, our discovery in the litigation disclosed that the members of the group desire that K N increase the level of gas drilling and production so as to accelerate the sale of gas owned by the company, as contrasted with the company's policy of less rapid production with a view toward protecting the future supply for its gas customers. The members of the group have also given consideration to complying with the Holding Company Act, should the Act be or become applicable, by divesting K N's gas distribution properties and retaining its gas production properties. We strongly believe that these changes in policy would be adverse to the interests of our investors and consumers, in conflict with our public utility obligations, and inconsistent with the objectives of the Holding Company Act as well as our local regulatory statutes.

2. IF KN BELIEVES THAT S.1174 PROPERLY MOVES IN THE DIRECTION OF RELAXING PRESENT RESTRICTIONS ON DIVERSIFICAITON UNDERTAKEN BY A PUBLIC UTILITY COMPANY OR PERMISSIBLE HOLDING COMPANY, DO YOU HAVE ANY COMMENTS ABOUT THE PARTICULAR PROVISIONS OF S.1174 IN THIS REGARD?

Broadly speaking, the provisions appear to provide reasonable limits and workable procedures with regard to diversification undertaken by a utility company or permissible holding company (as distinguished from superimposed diversification resulting from an outside takeover). However, I have not studied the provisions closely enough to say that I would agree with them in every detail or would disagree with any suggested modification.

3. IN VIEW OF THE GOVERNMENT'S BASICALLY NEUTRAL POLICY TOWARD CORPORATE TAKEOVERS, AS EXPRESSED IN THE WILLIAMS ACT, WHY SHOULD AN ANTI-TAKEOVER LAW FOR UTILITIES AS IN SECTION 9(a)(2) OF THE PRESENT HOLDING COMPANY ACT BE MAINTAINED, AND WHY SHOULD IT BE STRENGTHENED AS IN SECTION 9(a)(3)?

One basic original purpose of the Act -- not affected by S.1174 -- is to prevent the building up of new combinations of unintegrated utility properties. Hence, the emphasis of Section 9(a)(2) is on acquisitions of two or more utilities, and the procedural arrangements in Sections 9 and 10 are such that an incipient problem of this sort can be nipped in the bud, rather than having to be dealt with, after the fact, by undoing a completed transaction.

However, combinations of non-integrated utility properties are not the only impermissible results under Section 11. It is also impermissible to have overly complicated corporate structures, utilities controlled by means of pyramiding or disproportionately small investment, or utilities controlled by remotely located holding companies that are primarily engaged in other businesses, are not sensitive to utility-type obligations, and are likely to frustrate localized management and effective state regulation. These latter impermissible situations can come about through the acquisition of control of a single utility company, without any combination of two or more non-integrated utility companies. Accordingly, Section 9(a)(3) would perform the same function for this kind of problem that Section 9(a)(2) now performs for the problem of combinations of non-integrated utility operations. That is to say, it would provide a procedural framework for nipping in the bud any impermissible situation under Section 11 that might result from a single utility acquisition, i.e., a "first bite," rather than -- as at present -- limiting the Commission to acting after the fact, when it must order reversal of a completed transaction that should not have been allowed in the first place.

I greatly appreciated the opportunity to present K N's position to the Subcommittee on June 14 and welcome this opportunity to be of further assistance to the Subcommittee on this important issue. If any further information is needed, please let me know.

Respectfully submitted,

E J Jackson

EJJ:llf

cc: The Honorable Paul S. Sarbanes

[Appendix 1]

70th Congress *1st Session*	SENATE	Document 92 Part 73-A

UTILITY CORPORATIONS

SUMMARY REPORT
OF THE
FEDERAL TRADE COMMISSION
TO
THE SENATE OF THE UNITED STATES
PURSUANT TO SENATE RESOLUTION No. 83
70th CONGRESS, 1st SESSION
ON
HOLDING AND OPERATING COMPANIES OF ELECTRIC AND GAS UTILITIES

No. 73-A

Survey of State Laws and Regulations
Present Extent of Federal Regulation and the Need of Federal Legislation
Conclusions and Recommendations and Legal Studies in Support Thereof

Filed with the Secretary of the Senate
January 28, 1935

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1935

financially interested in financial, engineering, construction, and/or management corporations, and the relation, one to the other, of the classes of corporations last named, the holding companies, and the public utility corporations; (4) the services furnished to such public utility corporations by such holding companies and/or their associated, affiliated, and/or subsidiary companies, the fees, commissions, bonuses, or other charges made therefor, and the earnings and expenses of such holding companies and their associated, affiliated, and/or subsidiary companies; and (5) the value or detriment to the public of such holding companies owning the stock or otherwise controlling such public utility corporations, immediately or remotely, with the extent of such ownership or control, and particularly what legislation, if any, should be enacted by Congress to correct any abuses that may exist in the organization or operation of such holding companies.

The Commission is further empowered to inquire and report whether, and to what extent, such corporations or any of the officers thereof or any one in their behalf or in behalf of any organization of which any such corporation may be a member, through the expenditure of money or through the control of the avenues of publicity, have made any and what effort to influence or control public opinion on account of municipal or public ownership of the means by which power is developed and electrical energy is generated and distributed, or since 1923 to influence or control elections: *Provided*, That the elections herein referred to shall be limited to the elections of President, Vice President, and Members of the United States Senate.

The Commission is hereby further directed to report particularly whether any of the practices heretofore in this resolution stated tend to create a monopoly, or constitute violation of the Federal antitrust laws.

Senate Joint Resolution 115, Seventy-third Congress, second session, May 28, 1934, provided as follows:

Whereas it is learned that the Federal Trade Commission, because of lack of time, money, and personnel, intends to close its utilities investigation under Senate Resolution 83, Seventieth Congress, first session, without investigating various important corporations included among those described in said resolution:

Whereas it is in the public interest that certain of said corporations be investigated: Therefore be it

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled, That the Federal Trade Commission be, and it is hereby, authorized and directed to proceed under the Senate resolution aforesaid until it has investigated such of said corporations as in its judgment should be investigated, but the investigation shall be completed and the Commission's final report, with recommendations, shall be submitted to the Congress not later than the first Monday in January 1936.

Under the terms of said resolutions, the Commission's investigation has been confined to gas and electric utility holding companies, and their associated, affiliated, and subsidiary companies. The mandate to the Commission only calls for a report and recommendations upon the holding companies of such gas and electric utilities. Whether any legislation as to holding companies shall be of general application is a question of policy for the determination of the President and the Congress.

A somewhat different set of facts and legal questions arise concerning holding companies outside of the utility field. The Federal Trade Commission has had considerable and varied experience in the matter of general industrial holding companies, but makes no recommendations herein relative thereto, as the resolution of the Senate only calls for the facts, conclusions, and recommendations as to utility holding companies. However, it is believed that such holding companies and the elaborate and complicated systems disclosed in this investigation either present or indicate the main types and salient features of holding company abuses and problems.

Summary and Conclusions

In carrying out the mandate of the Senate this Commission examined the records of 18 top or apex holding companies, 42 sub holding companies, and 91 operating companies of said groups. While the resolution asks for recommendations as to legislation, if any, to correct abuses of holding companies, it directed inquiry into operating companies, and it was deemed especially essential to examine the 91 operating companies examined in said groups in order to present a fair and understandable picture of the effects of the holding companies upon the operating utilities. The 91 operating companies examined show a ledger value of aggregate total assets for the last year reported upon $3,987,854,063. The 42 sub holding companies for the same years show aggregate total corporate assets of $3,155,030,623. The 18 top holding companies examined show for the same years aggregate corporate assets of $4,119,769,627. The above figures are all ledger values and include, for each group, elements of inflation, elsewhere described.

In the course of this investigation the Commission has filed with the Senate 73 different monthly reports, containing reports by members of the Commission's staff and testimony and numerous exhibits. All of such volumes up to and including volume 64 have already been printed as parts of Senate Document 92, Seventieth Congress, first session (including certain additional exhibit volumes). The remaining 10 volumes are now being printed. The Commission has recently filed with the Senate a summary report (71–A) on association propaganda activities of the electric and gas industry. While most of the more important holding company groups have been examined, there still remain a few in the electric field which will be examined during the extension of time directed by the last Congress and will be reported on subsequently. However, the investigation into natural-gas holding companies, and especially of the natural-gas pipe-line companies, will be the chief task during the coming year and will be reported on at the close of the investigation.

While the resolution defines generally the scope of the inquiry, the preceding chapters of this report give a more detailed statement of the facts developed in this investigation. However, even in these various chapters it has been possible, with due regard for brevity, to present such subjects as corporate organization, fixed capital, other investment accounts, and intercorporate practices by illustrative or typical examples only. This seems to be sufficient because the interim reports already sent to the Senate present the matters at length and are all printed public records. Even within such a limitation to illustrative examples, a listing from chapters V to IX (both inclusive) of this report, shows that the different and separate questionable acts run well into the hundreds. Most of these were either acts of the holding companies themselves or within their systems, or imposed directly or indirectly upon their operating companies.

A list of the questionable practices is attached to part 72–A as appendix A. Such acts and abuses are too various to recite here in detail but the numerous evil conditions and practices discussed in the preceding chapters may for the most part be classified under the following general heads:

(1) Pyramiding companies owning or controlling the operating companies for the purpose of enabling a minimum of investment to control a maximum of operating facilities, involving a greedy and highly speculative type of organization detrimental to the financial and economic welfare of the Nation.

(2) Loading the fixed capital account of public utilities with arbitrary or imaginary amounts in order to establish a base for excessive rates.

(3) Writing up the fixed assets without regard to the cost thereof, with the result of watering the stock or creating a fictitious surplus.

(4) Engaging in transactions of purchase and sale of property or securities with controlled or subsidiary companies for the purpose of recording arbitrary profits or fixing valuations unjustified by market values.

(5) Exaction of payments from affiliated or controlled companies for services in excess of cost or value of such services.

(6) Gross disregard of prudent financing in excessive issues of obligations, imperiling the solvency of the company and involving excessive charges for interest, discount, commissions, redemption, etc.

(7) Manipulating the security markets to deceive stockholders, bondholders, or potential purchasers of its securities.

(8) Putting funds in the call-loan market with the result of greatly stimulating speculation.

(9) Excessive use of conversion privileges for bonds and preferred stocks and of purchase warrants and options with the effect of inducing investors to part with conservative investments for speculative ones.

(10) Misstatement of earned surplus, or failure to distinguish earned from capital surplus, and making payment of dividends from the latter.

(11) Deceptive or illusory methods of dividing, or pretending to divide earnings or profits.

(12) Including imaginary (or "putative") interest in construction costs of a public utility and counting it as a part of earnings.

(13) Deceptive or unsound methods of accounting for assets and liabilities, costs, operating results and earnings, including write-ups unrealized or fictitious profits, stock dividends, etc.

(14) Corporate organization which gives powers inconsistent with a just division of responsibilities and emoluments as between various groups or parties furnishing capital by loan or by contribution, either directly or indirectly by purchase, succession, or otherwise.

(15) Issuing special voting or management stock giving control at small cost in order to promote the interests of selfish cliques, against the interest and safety of the general stockholders.

(16) Unsafe or mischievous methods of securing loans to the detriment of the lender.

(17) Intercompany financing on a basis disadvantageous to operating company borrowers or lenders.

(18) Evasion of State laws in effecting sales of security issues.

(19) Effecting pretended corporate reorganizations principally for the purpose of evading the payment of Federal income taxes.*

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* See: Evelyn F. Gregory, Petitioner, v. Guy S. Helvering, Commissioner of Internal Revenue; decided January 7, 1935, United States Supreme Court (55 S. Ct. Reporter 266; 293 U. S. —).

In the last analysis the foregoing practices and the conditions which they have created must be judged not only by economic results but by ethical standards. It is not easy to choose words which will adequately characterize various ethical aspects of the situation without an appearance of undue severity. Nevertheless the use of words such as fraud, deceit, misrepresentation, dishonesty, breach of trust, and oppression are the only suitable terms to apply if one seeks to form an ethical judgment on many practices which have taken sums beyond calculation from the rate paying and investing public.[1]

The evils recited have flourished in spite of such regulation as has existed. As shown in an exhaustive study made by this Commission, printed in part 69A, and discussed at length in chapter XII of this summary report, such evils have to a substantial degree resulted from and even been promoted by legislation and policies in some of these States. It is there shown that no substantial progress is being made, or can be made, by the States generally, toward effective regulation of holding companies. In a few States efforts are being made but generally the situation remains as it was 25 years ago, in spite of the rapid expansion of the holding-company systems and an even more rapid growth of resultant abuses. This refers particularly to the holding-company situation, because there the power of the States is, at best, handicapped by nonresidence and other causes. These compel the States, when any regulatory attempt is made, to resort to indirect methods of control, rather than to direct specific remedies. The States in general are quite helpless when certain of the States grant roving charters with practically unlimited power in what Justice Brandeis has characterized as a race "not of diligence but of laxity."[2] General concerted or uniform legislation by the States is highly improbable. Appropriate Federal legislation would serve the twofold purpose of being regulatory in itself and of rendering futile provisions of the character mentioned and embodied in charters granted by some States.

The holding company in the utility field has been the chief device by which the control and ownership of operating companies has been rapidly concentrated into fewer and fewer hands with every prospect that the process will continue on to Nation-wide monopoly unless there be governmental regulation.[3]

Due to a variety of causes, some perhaps proper and natural, this process of concentration has produced a vast superimposed structure of corporations which must, each in turn, derive its revenue from its underlying operating companies. These holding companies and their associated companies have generally issued securities of great variety and grade of preference, and frequently in excessive amounts.[4] Their soundness must ultimately depend upon the revenues of the underlying operating companies. Inevitably this leads to pressure in many forms to derive the desired revenues from such operating companies and therefore has a substantial effect upon rates.

Many claims are made as to the advantages and functions of these holding companies. It is claimed that they afford advantages of supermanagement by staffs of highly skilled experts which independent operating companies cannot afford. It is also claimed that advantages result from group financing and from group purchasing. A large part of these claims have been seriously challenged. Some existing independent operating companies, both privately owned and municipal systems, particularly among the larger ones of each class, stand as contradictions to practically all such claims. Moreover, holding companies have acquired control of operating companies so large that the argument of the latter's inability to provide such services for themselves obviously has no application. The Commission is of the opinion on the whole that the detriment of utility holding companies to the public has exceeded, thus far, their value to the public.

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[1] Compare article by President Roosevelt in Liberty, Sept. 10, 1932, p. 35.

[2] 288 U. S. 517.

[3] See ch. IV, pt. 72–A.

[4] See ch. VI, pt. 72–A.

Summed up, the abuses of the holding company fall chiefly into two classes:

(1) Unsound and/or needless financial structures and practices which are a detriment and frequently a menace to the investor or the consumer or both.

(2) The milking of operating companies through the device of numerous form of contracts and arrangements. The Federal Trade Commission's investigation has disclosed that the tributes and profits thus exacted have in some instances ranged from 50 percent to over 300 percent on the cost of such services.[1]

The holding company, as such, performs no producing function. For that reason, in the utility field it has not been treated as a utility company and therefore has not been subject to regulations as such. It is usually subject to no regulation or control whatever. Operating utilities are the companies to which the Commonwealths have granted the charters to perform a general public-utility service. These grants imply and definitely impose reciprocal duties, but as a result of holding-company control and management, many operating companies, under the compulsion of holding company control, have contracted away the real performance of their principal charter functions to the holding company or to other companies designated by the holding company, thus leaving only a hollow corporate shell within the jurisdiction of the State where the operating company does business. The entire holding company problem has grown up under the enactment of statutes which abrogated the common-law rule which forbade one corporation to acquire and own stock in another. Corporations, including holding companies, have traveled a long way from the time when a few persons incorporated for the benefit of their combined resources and combined ownership, with the combined advice and management of the owners. Holding-company corporations have stretched this still further until often there has been practically complete divorcement of ownership from management and responsibility. In fact, the very nomenclature now adopted illustrates this. The public is no longer invited to buy an interest in the control and management of the corporation. They are invited to "invest." Much of the induced investment is of nonvoting stock, and even when it is of voting stock, the wide dispersion thereof makes practically impossible any combined action against any managerial group that has once acquired control. Thus instead of the corporation, on the one side, and the public, on whom it will depend for trade and revenue, on the other, as was the case originally, we have a third party of minority ownership but with management and control which may be likened to absentee landlordism. Obviously, whenever this managerial group becomes swayed with lust for power and greed for excessive profits, the many other stockholders are treated as having few, if any, rights. In many instances, such managerial groups have failed to act as trustees for their corporations and other stockholders, as in equity they are supposed to do.

Discussion of Remedial Legislation

As previously stated, the Commission is directed to recommend—

> what legislation, if any, should be enacted by Congress to correct any abuses that may exist in the organization or operation of such holding companies.

The objective is restoration of soundness and common honesty in corporate and particularly in holding-company affairs and structures. It is to restrict the capitalization and rate base to a sound and correct basis not in excess of honest prudent investment; to reunite ownership with control and responsibility; to compel the return of the controlling management to the position of being and functioning in all respects as trustees in fact for the corporation and guardians of its welfare; to reorganize on a sound and uniform basis the entire corporate structure; to simplify and regulate intercorporate relations; to require proper accounting with respect to the values of assets, whether in plant or in security investments, and also with respect to actual income and net profit; to eliminate the exploitation of one corporation by another which controls it; to abolish the manipulation of securities in the market or the speculation of officers and directors in the securities of their own companies.

The pertinency of some recommendations will depend on their relation to the fundamental policy which may be adopted. In response to the Senate resolution, this Commission conceives it to be its duty to make such suggestions as the Commission believes to be constitutional and workable and which may possibly aid the Congress in the determination of the character and form of such legislation as may be decided upon. If the public policy is to be one of toleration and regulation of holding companies, certain types of recommendation will be in order. If the public policy is to be one of suppression of holding companies, other recommendations are called for. There is also possible a form of regulation whose main purpose is a partial suppression through restriction. The weight of any given recommendation must be judged by its relation to the fundamental policy which it seeks to effectuate. Which of the above two fundamental policies shall be pursued is of course for the Congress to determine.

The choice between suppression and regulation of holding companies will turn logically upon a balancing of their relative advantage and detriment to the general public. If they provide advantages to the public which can be obtained in no other way, then it may be desirable to preserve the holding company in order to preserve those advantages to the public. If those advantages can be obtained in some other way, then the argument for retention of the holding company is correspondingly weakened and the decision will turn more largely upon the eradication of evils than upon the preservation of benefits.

If there be no practicable or constitutional way of redistributing the assets of holding companies so as to dissolve their monopolistic elements, or if that is not desired, it might be wiser from a public

Public Utility Holding Company Act of 1935

[Public—No. 333—74th Congress, S. 2796]

AN ACT to provide for control and regulation of public-utility holding companies, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Public Utility Act of 1935."

Title I

Control of Public-Utility Holding Companies

Necessity for Control of Holding Companies

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; (2) their service, sales, construction, and other contracts and arrangements are often made and performed by means of the mails and instrumentalities of interstate commerce; (3) their subsidiary public-utility companies often sell and transport gas and electric energy by the use of means and instrumentalities of interstate commerce; (4) their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage; (5) their activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies.

(b) Upon the basis of facts disclosed by the reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session), the reports of the Committee on Interstate and Foreign Commerce, House of Representatives, made pursuant to H. Res. 59 (Seventy-second Congress, first session) and H. J. Res. 572 (Seventy-second Congress, second session) and otherwise disclosed and ascertained, it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of

the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

(2) when subsidiary public-utility companies are subjected to excessive charges for services, construction work, equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States;

(3) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such companies, or when control of such companies is exerted through disproportionately small investment;

(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties; or

(5) when in any other respect there is lack of economy of management and operation of public-utility companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.

(c) When abuses of the character above enumerated become persistent and wide-spread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

[APPENDIX 3]

SCATTERATION V. INTEGRATION OF PUBLIC UTILITY SYSTEMS

A Significant Statement of Official Attitude Made before the Section on Public Utilities at Its Meeting at Cleveland on July 26—As a "Practical Matter It Will Often Be Necessary to Accomplish the Ultimate Objectives of the Act by a Series of Steps Rather Than by One Direct and Final Step"—Provisions of Measure on Which Attack Has Centered—Policy of Act in Restricting Holding Companies—Discussion of Certain Arguments Against It—"We Have Entered on a Period of Constructive, Not Destructive Action"

BY HON. WILLIAM O. DOUGLAS
Chairman of the Securities and Exchange Commission

OBSERVATIONS, based on almost three years' experience with the Public Utility Holding Company Act of 1935, are, I think, in order. In the first place, we are well on our way, in spite of two years or more of litigation, towards accomplishment of many of the objectives of that Act. There has been rather wide acceptance of its standards respecting the issuance of securities and the acquisition of assets and securities. Progress has been made towards regularizing and reforming (where reform is needed) the accounting practices of public utility holding companies. A start has been made towards elimination of write-ups—the sand on which too many holding company structures were erected. Equally worthy of note, the requirements of the Act that servicing and management contracts with associate companies be based on cost seem to have been accepted by the industry. And furthermore, though we and the industry have barely started on the problems of corporate simplification and geographical integration, we are now seriously preparing to tackle them.

In the second place and based on this experience, I can say that those sections of the Act with which we have had experience have demonstrated their workability and practicability. They have proved themselves soundly conceived. They constitute a firm basis for mobile and flexible administrative action in a field which financiers aided and abetted by lawyers apparently have delighted in making complicated and obstruse.

In the third place, I can say that since the decision in the Electric Bond & Share case (where the Supreme Court upheld the constitutionality of the registration provisions of the Act) there has been increasing evidence of the willingness of substantial parts of the industry to go along with us—induced by their own self-interest; by recognition of the supremacy of the will of Congress; and by recognition on the part of operating heads of the enormous constructive possibilities of the Act. With this trend continuing, the next few years should produce real action towards realization of the objectives of the Congress and the President. I am confident that it will be in large measure joint action by the industry and us working together. I am also confident that it will be action by us alone where necessary, or where no progress or sincere effort is evident.

Further experience under the Act may demonstrate that amendments are necessary. If that turns out to be the case, I am sure that we will be the first to urge them. As evidence of my sincerity in this respect I need only point to the successful advocacy on our own initiative of amendments to the Revenue Act before the last Congress, in an effort to make the way of holding companies an easier one in complying with the requirements of Section 11 of our Act. But it can hardly be expected that amendments to an Act (as maturely considered and as vigorously debated line by line as was this one) constitute the sound course, in the absence of a genuine administrative effort to make the Act work. And certainly experience has not yet demonstrated the need of amendment.

As I have implied we are (because of the delay in litigation) barely on the threshold of the problems of simplification and integration under Section 11 of the Act. Hence it is as though Congress had just enacted these provisions. But the light in the eyes of an occasional conferee at our well-known round-table discussions at times reflects the hope in his breast that these provisions of Section 11 will be nullified by our inaction or that we will dodge the difficult and heavy responsibility which they impose on us by urging their repeal or substantial modification. Experience gained with practical problems may demonstrate the practical wisdom of some modification. But short of that we are bent neither on nullification nor repeal. Our round tables are designed for healthy cooperative action; not for a sabotage of a law validly enacted or for oblique avoidance of our mandate under the Act.

This is not to deny that the problems of corporate simplification and geographical integration are intensely practical and difficult ones. We recognized that in the case of American Water Works where we announced that "the problem of consummating integrated public utility systems under the Act is of necessity in many cases, an evolutionary rather than a revolutionary process. As a practical matter, it will often be necessary to accomplish the ultimate objectives of the Act by a series of steps rather than by one direct and final step." Adoption of this formula makes for workability and progress, in a field where words rather than action have been too long the keynote.

This inaction has in part been the product of misunderstanding. Prophets of disaster have usually through it) that the Act attempts to exert leverage on this problem of geographical integration. To put it simply: isolated and independent operating companies remain unaffected by Section 11[1]; a holding company must be confined (with few exceptions) to a single integrated public utility system. Theoretically then only a part of the private utility problem is touched by Section 11. Actually it has a pervasive effect on most of the industry in view of the dominance of the position of holding companies.

The policy of the Act in restricting holding companies to single integrated systems is not difficult to divine: In the first place, it reflects the desire to diminish concentration of control in the electric and gas utility industries. In the second place (and as a corollary of the first) it is designed to promote the formation of strong regional or local operating systems—rid of absentee management and remote financial control. On this matter the National Power Policy Committee has said:

> "Numerous studies have already shown, and the report of the Federal Trade Commission further demonstrates, that the concentration of control in the electric and gas industries through the device of the holding company has assumed tremendous proportions. While the distribution of gas or electricity in any given community is tolerated as a 'natural monopoly' to avoid local duplication of plants, there is no justification for an extension of that idea of local monopoly to embrace the common control by a few powerful interests, of utility plants scattered over many states and totally unconnected in operation. Such intensification of economic power beyond the point of proved economies not only is susceptible of grave abuse but is a form of private socialism inimical to the functioning of democratic institutions and the welfare of a free people."[2]

The fact is that the electric and gas utility industries have become essentially local monopolies by virtue of their economic characteristic: yet many of the large holding company systems have succeeded in expanding their financial and economic control far beyond any reasonable limits. In Section 11, Congress has ruled that the financial and economic power of the utility holding company must conform, roughly speaking, to the economic area of the regional or local operating monopoly. Section 11 places a natural limitation upon concentration of control, for as different systems map out their single integrated service areas and in the process acquire the scattered properties of other systems, each system's boundaries impose a limit upon the future expansion of its neighbors. In contrast, when a holding company system could pick up properties anywhere and such properties did not have to be geographically related, there was no effective limitation upon the size of a holding company system or the number of units which it might control.

The philosophy is that while our technological advances have created economic principalities in many spheres of national activity, the size and power of these principalities must correspond with the economic or social facts. No man or group of men should be permitted to expand this financial and economic control beyond limits justified by those facts. In the electric and gas industries, as in some others, a situation which logically arose because of certain inherent operating characteristics was pushed far beyond its logic. The local units of the electric and gas industries have been referred to by some as "natural monopolies" and they have been given peculiar legal status because of the characteristics which led to this designation. This may have been wholesome and desirable; but, if so, one of the factors which made it such was the essentially local characteristic of these industries.

Now, one of the consequences of this status was some stabilization of rate of return for these industries. But this stabilized return made these industries peculiarly attractive to those who had a lust for power and profit. These persons collected more and ever more electric and gas companies and properties and combined them into huge holding company systems. The result was not merely absentee ownership, but absentee management and remote control. An essentially local industry was managed from a far distant metropolis. It was run not merely to serve the local consumers and the people who had invested their money in that company, but as part of a huge empire. It was, so to speak, a member of a scattered family with the controlling grandparent dwelling in distant parts. The local or regional unit lived not for itself, but for all of its kin. If money were needed in any part of the holding company's system, a local company was subject to raids of one sort or another to produce that money to support the ailing members. In many instances its officers and employees were used to sell securities of its remote parent or of one of its remote brothers. Its good will was dependent not upon the local life of which it was essentially a part, but upon the fortunes of dozens of remote brothers or second cousins and the vagaries and humors of several degrees of parents.

In Section 11 of the Holding Company Act, Congress has recognized not merely that reorganization of the electric and gas utility industries on a regional basis is necessary in order to promote their health, but also that the huge scattered empires must be broken up into regional systems in order to prevent the destruction of the utility industry itself. This is the philosophy of the statute. And I, like all others who believe in keeping business at home, think this philosophy is sound. And there is strong support for it in the industry itself. An executive of a holding company system soon to be revamped under the Act said this to me recently, with reference to Section 11:

> "Integration of generation, of natural trade areas, and diversity factors are a very sound background upon which to reset the operating companies of the nation. The electric power industry has only one reason for existence and that is to render dependable service as cheaply as possible. To do this the capital invested must have reasonable certainty of return. The corporate form that it takes should be simple and understandable and workable. The management should be as close as possible to the territory served

And the staff of the New England Power Associa tion recently laid on my desk an interesting analys and justification, from an operating and engineerin point of view, of the philosophy of Section 11. The paper said in part:

> "The development of the electric power industry the United States has brought about the existence of fo broad classes of electric utility units. One is the sm and constantly decreasing number of isolated local unit isolated as to electric connection with their neighbors a local in their management. Another is the group in wh the units are under common management but which a not physically connected each to the other. The third cla

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[1] Isolated companies (rid of holding company control) may be expected to respond to technological and operating considerations in development of integrated units—perhaps in some cases to state-wide integration. This is not to mention the important realm of state regulation not affected by the Act.

[2] *Report of National Power Policy Committee on Public Utility Holding Companies* (1935) H. R. Doc. No. 137, 74 Cong., 1st Sess. at 4.

[Appendix 4]

MILTON H. COHEN

STUDY OF OPERATIONS PURSUANT TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

HEARINGS

BEFORE THE

SECURITIES SUBCOMMITTEE OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

SEVENTY-NINTH CONGRESS
SECOND SESSION

ON

REPRESENTATIVES OF THE
SECURITIES AND EXCHANGE COMMISSION

MARCH 25, 26, 27, AND 28, 1946

REPRESENTATIVES OF
SECURITIES AND EXCHANGE COMMISSION

APPENDIX 1

MATERIAL REQUESTED OF S. E. C.

APPENDIX 2

ADDITIONAL STATEMENTS SUBMITTED
DOCUMENTS SUBMITTED

PART 3

Printed for the use of the
Committee on Interstate and Foreign Commerce

STUDY OF OPERATIONS PURSUANT TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

MONDAY, MARCH 25, 1946

House of Representatives,
Subcommittee of the Committee on
Interstate and Foreign Commerce,
Washington, D. C.

The subcommittee met, pursuant to call, at 10 a. m., in the committee room, New House Office Building, Hon. Lyle H. Boren presiding.

Mr. **Boren**. The committee will please come to order.

I am sure that the other members of the committee will be here very shortly. The Chair has had a message from most of them, and although I regret to start without a quorum in attendance, I feel that in conservation of our time and yours, Mr. Purcell, we should go ahead.

The committee is met in furtherance of the study of the liquidation processes under the Holding Company Act of 1935 and particularly to hear the Securities and Exchange Commission as to their answers to suggestions made and any suggestions the Securities and Exchange Commission might care to make to the committee.

We have Mr. Purcell on the stand, and you may proceed in your own way, Mr. Purcell.

STATEMENT OF GANSON PURCELL, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. **Purcell**. Thank you, Mr. Chairman.

We are here today to continue our statement in behalf of the Securities and Exchange Commission in response to the committee's invitation to submit comments on possible amendments to the Holding Company Act.

Our presentation will consist of the following parts: First, I shall outline certain general considerations forming the background against which any specific amendments must be viewed. This background material is brief, almost to the point of presenting you with an inadequate picture of the data and information which will be helpful to you in considering these amendments, but, because of the expressed desire of the committee for brevity we have not attempted to give you more adequate background materials. Second, we shall comment on the various amendments which have been proposed by industry witnesses in the past few months. Mr. Milton H. Cohen, Director of our Public Utilities Division, who appeared previously on ovember 12, 1945, will present these comments, which will constitute he greater part of what we have to say. Third, after Mr. Cohen has iven you our comments on these various proposals to amend the act, will give you our recommendations on the question of whether the ct is in need of amendment. Finally, I will have some brief comments concerning the public power question which has been brought nto the proceedings from time to time by the various witnesses. Both Mr. Cohen and I, of course, will be available to answer questions on any spects of our presentation to the best of our ability.

Our testimony will cover only the major points raised by the industry witnesses. The testimony of the industry witnesses, as well as the testimony of the nonindustry witnesses who appeared to propose changes in the act, contain, we believe, many factual misstatements which should not be allowed to stand uncorrected in the record of these proceedings. We will not, however, take the time to point se out to the committee in our oral testimony, but we beg leave hin a few weeks after the termination of our oral presentation to submit to you a written memorandum for insertion in the record correcting such statements, if that would be satisfactory to the committee.

Mr. Boren. The Chair feels that if you care to comment on that, the committee would certainly like to have any matters of fact bearing on the testimony, and we will welcome such a statement, Mr. Purcell. The only sugestion that the Chair makes is that it be presented as promptly as possible in order that the study may be completed.

Mr. Purcell. So that the printing and other things may not be held up.

Mr. Boren. Yes.

Mr. Purcell. We will do it just as rapidly as we can, but we thought that it would be better to submit it in this form rather than extend our oral presentation that far.

Mr. Boren. That will be fine.

Mr. Purcell. Chairman Boren has stated on the record of these proceedings on numerous occasions that the design and purpose of the subcommittee is not to cover any fundamental change in the conception the Holding Company Act but merely to consider administrative problems arising in 10 years' experience under the act which might necessitate minor changes to plug up loopholes and the like. If the industry witnesses had adhered to this clear limitation of the scope of this inquiry, the material to be presented by Mr. Cohen commenting on the specific amendments would have undoubtedly been far briefer and more promptly presented. But, instead, as we will later demonstrate, the industry witnesses have proposed fundamental and far-reaching amendments—no less so because they have been presented under the guise of minor verbal changes or with disclaimers of drastic intent—and we have no other course but to take the time necessary to demonstrate exactly how fundamental and far reaching the amendments would be and why the public interest and the interest of investors and consumers requires, in our opinion, that they be rejected.

I do not know to what extent the presentation of the various industry witnesses has resulted from concerted planning through industry-wide organizations, such as the National Association of Electric

Compannies. .But I think it is interesting to note the following phenomenon which may be a mere coincidence: Practically every industry witness stated that he was not proposing fundamental or numerous changes in the law. Yet, when we fit together, like pieces in a jigsaw puzzle, the two or three suggestions coming from each of the numerous witnesses, under the guise of "clarifying amendments," we find that altogether they reach substantially every provision in the statute, and that their combined effect would be to remove or restrict every important regulatory provision of the statute and substantially to destroy its effectiveness as a regulatory measure.

Thus, one witness proposes a so-called clarifying amendment in section 2 or section 11, another in section 3 or section 13, another in the text of section 5 or 21 but relating to sections 6, 7, 9, 10, 12, and 15. One witness suggests broadening the exemptions while another would cut down the regulation of nonexempt companies. One amendment would remove restrictions against retaining nonutility subsidiaries, another would remove the power to regulate those which are retained. One amendment would modify the size standard of section 11 (b) (1), another deals only with the geographic standard, and a third would change the burden of proof of that section. One witness touches only on section 11 (b) (1), another only on 11 (b) (2), and so on. Add them all together, the two or three changes here and there suggested by each of the industry witnesses, and the Holding Company Act is virtually gone. Hence, we feel that it is of highest importance to demonstrate how far the witnesses have gone beyond the subcommittee's original purpose, and how fundamental and far reaching and drastic the proposed amendments really are. Since these amendments relate to every important provisions in the statute and potentially raise anew every fundamental question of policy entering into its legislative history, and since the proponents have, all told, covered some 700 pages of the transcript in stating their views, our statements on such amendments must necessarily be somewhat extensive even though we confine them to the barest essentials.

Before we turn to the amendments themselves, we think it necessary to recall very briefly the situation which led to passage of the act, the purposes which it was intended to accomplish, and what has in fact been accomplished since its enactment.

We think it unnecessary to take the committee's time to recall to it in any detail the evils and abuses which moved Congress to enact the Holding Company Act. As the committee is aware, the Holding Company Act was passed with express reference both to the comprehensive study of the industry contained in the ninety-odd volumes of reports of the Federal Trade Commission, Seventieth Congress, first session, Document 92, which has been characterized as "the most thoroughgoing investigation of an American industry that has ever appeared" (Barnes, the Economics of Public Utility Regulation), and the six-volume Splawn report of the House Committee on Interstate and Foreign Commerce (73d Cong., 2d sess., H. Rept. No. 827). I respectfully refer the committee to volume 72-A of the Federal Trade reports which contains a well documented summary of the findings of the previous volumes, and to volume 73-A which marshals the numer-

vil conditions and practices then prevalent, some of which may
oted as follows [reading]:

yramiding companies owning or controlling the operating companies for
urpose of enabling a minimum of investment to control a maximum of
ting facilities, involving a greedy and highly speculative type of organ-
on detrimental to the financial and economic welfare of the Nation.
Loading the fixed capital account of public utilities with arbitrary or
nary amounts in order to establish a base for excessive rates.

* * * * * * *

Exaction of payments from affiliated or controlled companies for services
cess of cost or value of such services.
Gross disregard of prudent financing in excessive issues of obligations, im-
ing the solvency of the company and involving excessive charges for interest,
unt, commissions, redemption; etc.—

. WINTER. Mr. Purcell, may I ask you a question?

Ir. PURCELL. Yes, Mr. Winter.

Mr. WINTER. In your testimony, or in the testimony of others,
you going to set out for the committee how these amendments
affect changes in the act?

Mr. PURCELL. Yes, sir. Mr. Cohen, who will follow me, will take
one by one and in as much detail as we think necessary. [Reading:]

13. Deceptive or unsound methods of accounting for assets and liabilities,
ts, operating results and earnings, including write-ups, unrealized or fictitious
its, stock dividends, etc.
4. Corporate organization which gives powers inconsistent with a just division
esponsibilities and emoluments as between various groups or parties furnish-
capital by loan or by contribution, either directly or indirectly by purchase,
cession, or otherwise.

* * * * * * *

17. Intercompany financing on a basis disadvantageous to operating company
rrowers or lenders.
18. Evasion of State laws in effecting sales of security issues.

In characterizing these practices and conditions the Federal Trade
ommission stated [reading]:

the last analysis the foregoing practices and the conditions which they
e created must be judged not only by economic results but by ethical stand-
rds. It is not easy to choose words which will adequately characterize various
thical aspects of the situation without an appearance of undue severity. Never-
heless the use of words such as "fraud," "deceit," "misrepresentation," "dis-
onesty," "breach of trust," and "oppression" are the only suitable terms to
pply if one seeks to form an ethical judgment on many practices which have
aken sums beyond calculation from the rate-paying and investing public.

In section 1 of the act Congress expressly referred to the evil prac-
ices and conditions which were prevalent and declared, in sec-
tion 1 (c), that the policy of the act [reading]:

in accordance with which policy all the provisions of this title shall be inter-
preted, [is] to meet the problems and eliminate the evils as enumerated in this
section, * * *

It is important to note that it was not the Federal Trade Commission or the SEC but the Congress itself which made and declared this policy which underlies the act and furnishes the fundamental basis for interpreting its provisions. Moreover, the adoption of such policy by Congress was preceded by a legislative history which, in addition to the comprehensive investigations by the Federal Trade Commission and the Splawn committee to which I have referred, included extensive hearings before the House and Senate committees and debate on the floors of Congress. The hearings before the House committee consumed 33 days and the record of the hearings, which exceeds 2,300 printed pages, includes the testimony of about 50 witnesses, representing the industry and the Government, and communications from some 30 other persons, including public utility and holding companies. The hearings before the Senate committee took 11 days and cover in excess of 1,100 printed pages containing the testimony of 21 witnesses, memoranda submitted by representatives of the Government, and briefs submitted by holding companies and other representatives of the industry. The debates in Congress covered a period of some 7 months and are contained in some 730 pages of the Congressional Record.

The disastrous effect upon the investing public of the conditions and practices to which I have referred is graphically illustrated in statistics which indicate that from September 1, 1929, to April 15, 1936, 53 holding companies went into receivership or made applications for relief under section 77B of the Bankruptcy Act. The aggregate capitalizations of these holding companies represented by their outstanding securities in the hands of the public totaled in excess of $1,600,000,000. Twenty-three additional holding companies with publicly held securities exceeding $530,000,000 offered readjustment or extension plans after defaulting on interest payments. As to the preferred stocks of holding companies, while we do not have available the statistics as of 1935 we do have them as of December 31, 1938, the year in which most of the holding companies registered following the decision of the United States Supreme Court upholding the constitutionality of the registration provisions of the act. They indicate that, as of December 31, 1938, registered holding companies had outstanding in the hands of the public $2,083,000,000 of preferred stock (on an involuntary liquidating basis), of which more than half, or $1,169,000,000 were in arrears, the total arrearages as of that date aggregating approximately $282,000,000.

Serious injury also resulted to investors in many of the public utility operating subsidiaries of the holding companies. From September 1, 1929, to April 15, 1936, the same period that I gave above, 36 public utility operating companies, with outstanding securities in the hands of the public of $345,000,000, went into bankruptcy or receivership. Sixteen additional companies, with $154,000,000 of securities outstanding in the hands of the public, offered readjustment or extension plans after defaulting on interest payments. Public investors in the preferred stocks of operating companies, totaling $1,508,000,000 at December 31, 1938, also suffered seriously. Mismanagement and exploitation by holding companies through excessive service charges, excessive common stock dividends, upstream loans, and an excessive proportion of senior securities, were among the factors which led to an accumulation of arrears at December 31, 1938, of $90,000,000 on preferred stocks of the face amount of $412,000,000.

The Federal Trade Commission reports demonstrate that in the organization and growth of public utility holding company systems the leading roles were not played by engineers and other experts in the operations of public utility companies, but by investment bankers who created some of the largest of such systems for the purpose of

ing new clients or protecting existing banking relationships.
J. P. Morgan & Co. and others organized the superholding
ıy, known as the United Corp., and as a result found them-
as the Federal Trade Commission reported—

> tical control of a network of utilities that extended, with only one im-
> t break, from the Great Lakes and the St. Lawrence River to the Gulf of
> (Federal Trade Reports, vol. 72-A, p. 111).

ilarly, H. M. Byllesby & Co., investment bankers, controlled
ast Standard Gas & Electric Co. system. This system, com-
g over $820,000,000 of assets, was subjected to intense and
competition between various investment-banking groups for
ol. Standard Gas was among those holding companies which
forced to file a voluntary petition under section 77B of the
ruptcy Act.

e evil practices and conditions to which I have referred flourished
te of such regulation as then existed. Then, as now, some mem-
f the industry urged that State laws and administrative measures
otected the public interest that not even Federal investigation
olding-company systems, quite apart from Federal regulation
ch systems, was called for. But the Federal Trade Commission,
subsequently the Congress, found State regulation inadequate,
ly because such regulatory efforts were circumvented and frus-
d through the holding-company device. While the State com-
ons dealt with local officials, they in turn were subject to the
erity of the absentee managers in the holding company who were
ed in remote financial centers without concern or responsibility
rd local development, but interested primarily in the financial
uments attendant upon control. They deliberately created cor-
te complexities to baffle State commissions or to circumvent State
ry. A State utility commission might have complete jurisdic-
over the accounts, records, and practices of the local operating
v, but it still could not ascertain the most elementary facts
.t to effective regulation without examining the holding com-
v's books, which were usually inaccessible.

this connection, I should like to take a moment or two to read
w passages from a document in the public records of the Commis-
which furnishes a concrete example, and to distribute copies to the
mittee.

r. O'HARA. Will you pardon me, Mr. Purcell?

r. PURCELL. Yes, Mr. O'Hara.

r. O'HARA. Could you get us some copies of this that we could
d?

r. PURCELL. Are those the best we have? They are photostats
his copy, I take it, is the reason that they are indistinct.

r. O'HARA. Are they in your statement?

r. PURCELL. The portions I want to refer to are in the statement.
ink you can follow them. One reason for giving you photostats
as I will point out later, one of the most interesting part is the
rginal notes of the men who made up the reorganization program in
ly to the lawyer's comments and criticisms. For instance you will
d——

Mr. WINTER (interposing). Where did you get the original copy?

Mr. PURCELL. From the files of the Electric Bond & Share Co.

This document is dated in 1927, and is from the files of Electric Bond & Share Co., a holding company controlling 14 percent of the electric energy in the United States. It seems that the operating properties of the Electric Bond & Share system in the State of Pennsylvania were being reorganized into a larger operating company, and that one of the company's financial experts had drawn up a reorganization program. This program was reviewed by one of the Electric Bond & Share lawyers—a lawyer who later became president of the system—and he made the following comments, among others [reading]:

> As a general comment I suggest that as far as possible both reorganizations be run at the same time and in connection with each other; that is all agreements and all plans of reorganization should be laid so that no one will be able to separate one part of the reorganization from the other part. My reason for this is that while in the Pennsylvania Power & Light reorganization the increase in the plant account is apparently not so large, the increase of the plant account in the so-called Susquehanna Power & Light reorganization is tremendous, and we must not forget that in Pennsylvania the Commission has the right to approve or disapprove the acquisition of utility properties by a public utility.
>
> I suggest, therefore, so that the Commission will find it much more difficult to unravel the cost of the various properties, that we go before them with a plan that contemplates both the transfer of certain properties to Pennsylvania Power & Light Co. as well as the formation of a new utility company and also the transfer to the Lehigh Valley Transit Co. of the railway properties, so that it will be practically impossible for anyone to find out what the cost of any individual property was or the cost of any particular group of property. I believe that while you could get the Commission to approve your Pennsylvania Power & Light reorganization they would not approve the Susquehanna Power & Light reorganization but they might be willing to approve the reorganization of all your properties in Pennsylvania if it would be impossible for anyone to determine at what figure the various properties were going into the whole reorganization.

Now, if you will just skip two pages [reading]:

> I again desire to impress upon you the importance, in my opinion of scrambling all these reorganizations together so that about the only thing the Pennsylvania commission will be able to understand will be the result and not how the result was reached. Root's reorganization, in my opinion, is too simple and too easy to follow, particularly the plant account of the Susquehanna reorganization from $25,000,000 to $61,000,000 through a merger. I also desire to call your attention to the fact that Mr. Sawyer desires to talk over this whole matter with Governor Fisher, of Pennsylvania, and I believe that we do not want to put Mr. Sawyer in the embarrassing position of giving him a plan to submit to the Governor, which the Governor would approve if no figures were presented to him, and then have the commission refuse to approve the transfer of the utility properties because of the tremendous increase in plant accounts. The net result of Root's plan, as I see it, is to have the whole Susquehanna situation cost Lehigh—that is, the holding company—nothing, and while I believe that is a very salutary result in the ordinary case, I do not believe that we ought to risk obtaining this result by damaging our reputation before the Pennsylvania commission. Such a result, in my opinion, might start an investigation into our whole rate and financial structure in Pennsylvania and lead to all sorts and kinds of consequences.

While this memorandum itself is an interesting document, to say the least, in some respects its most striking feature consists of certain comments written in the margin by the author of the plan which was under criticism. For example, where the memorandum emphasized the importance of "scrambling" for purposes of obscurity, the marginal comment reads:

> This plan at its present stage is for home consumption only, and I tried to make it simple for that reason. Is not scrambling just a matter of presentation?

nd where the memorandum pointed out that there might be an estigation into the whole rate and financial structure in Pennvania if it were known that the holding company's cost was zero, marginal comment reads, "Don't see how commission"—that is Pennsylvania commission—"will see original costs, as they are on Lehigh books." Lehigh was a Delaware corporation whose oks were kept in New York.

It will be noted that the importance of accomplishing a write-up the accounts of the operating company was taken for granted, so t the discussion was confined to the methods of concealment. The jectives also included realizing the maximum capital gain possible r the holding companies involved, together with the achievement maximum leverage position for Electric Bond & Share—that absolute control with a minimum or no investment.

The consequences to the public involved in the transactions become pparent when they are followed through in the form they finally ook. The Pennsylvania company emerged with its plant account—nd no doubt it was hoped, its rate base—expanded by some $85,-00,000, which the operating company paid for by the issuance to he public of bonds, debentures and preferred stock. Of this amount $13,000,000 constituted immediately realized profit to the holding companies involved, of which $4,300,000 was derived by Electric Bond & Share itself. Studies recently concluded by the Federal Power Commission reveal that only $37,000,000 of the $85,000,000 represented the original cost of the utility assets. The excess of $48,000,000 consisted of approximately $18,000,000 of write-ups and the system profits to which I have referred, some $17,500,000 of acquisition costs incurred by the Bond & Share system, and approximately $12,700,000 of capitalized debt discount and expense. These facts indicate that all of the objectives were accomplished—the rate base was grossly inflated, a substantial profit was realized by the holding companies; and Bond & Share attained a maximum leverage position on the residual earnings f the properties, having recaptured its entire investment through sales to the public of senior securities.

However, in 1939 the Pennsylvania company, prior to requesting approval of the Commission of a refunding of its debt securities, removed from its plant account the financing costs of $12,700,000 to which I have referred. Further, pursuant to an order of the Federal Power Commission under the Federal Power Act, on December 31, 1945, the Pennsylvania company removed from its plant account approximately $26,200,000 of inflationary items and provided for the amortization of some $25,900,000 of additional intangibles. In addition, in a plan of recapitalization recently consummated in compliance with the standards of section 11 of the Holding Company Act, approximately $18,000,000 in cash was invested in the common stock of the Pennsylvania company, giving it its first real equity, and, further, provision was made for building up this equity to reasonably conservative proportions in the next few years. Of the $18,000,000 of this cash investment, $9,500,000 was invested by the public, and $8,500,000 by Bond & Share. This investment by Bond & Share represents its first real cash investment in the equity of the Pennsylvania company since 1920, when the company was organized under Bond & Share's auspices. Since that time, Bond & Share's subsidiary holding companies received in cash dividends from the Pennsylvania company in excess of $61,000,000, a substantial portion of which was in turn disbursed to Bond & Share. In addition, from the Pennsylvania company's inception in 1939, the Pennsylvania company paid to Bond & Share and its subsidiary service companies approximately $11,000,000 in servicing fees, on which Bond & Share estimates its profits aggregated $4,300,000.

I should like to supplement our relatively brief reference to the situation obtaining prior to the passage of the act by furnishing to the committee copies of a document entitled "Summary of Economic Data" which the Commission has filed in the courts in two or three litigated cases as a supplement to its brief. The facts and financial data therein summarized furnish indication of the extent to which the Nation's vital interest in its electric and gas public-utility companies had been seriously jeopardized by financial practices conducted in the interest of a small group of promoters and bankers; that public investors and consumers of such companies suffered heavily as a result of the practices which I have briefly described; and that a constructive program of rehabilitating and simplifying the corporate structures of holding company systems was highly desirable in the national interest. Such a program was provided by Congress in the Holding Company Act; and I should like now to tell you briefly about the actual administration of the act and what some of the accomplishments have been.

Under the act there are registered 54 public-utility holding company systems, the aggregate consolidated assets of which amounted to more than $16,000,000,000. These systems include 118 registered holding companies and 943 electric, gas, and nonutility subsidiaries as set forth in a document published by the Commission entitled, "Registered Public Utility Holding Company Systems, as of June 30, 1945"; and I should like to furnish copies to the committee. (See p. 1260.) A major part of the Commission's work under this statute since 1938 has been the task of passing upon the reorganization of the complex financial and corporate structures of these systems as required by section 11 of the act. The provisions of section 11 are designed to strengthen the capital structures of utility systems, to free the Nation's utilities from absentee holding-company domination and to return them to local management and State and local regulation. Section 11 (b) (1) of the act requires the limitation of each holding company system to a single integrated public-utility system with provisions for the retention of additional utility systems and related incidental businesses under certain designated circumstances. It is, in effect, a specialized antitrust act designed to meet the problem of the serious and uneconomic concentration of control of public utility companies. At the same time it affords holding companies the opportunity to build up and retain integrated public utility systems. Section 11 (b) (2) provides for the simplification of the structures of holding company systems, including the elimination of unnecessary and "great-grandfather" holding companies and the reorganization of holding companies which are unduly complicated and overcapitalized, and the redistribution of voting power among security holders of holding and operating companies.

Senator D'AMATO. Thank you very much, Mr. Jackson.
Mr. Nichols.

STATEMENT OF GUY W. NICHOLS, CHAIRMAN OF THE BOARD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEW ENGLAND ELECTRIC SYSTEM, WESTBOROUGH, MASS., ON BEHALF OF THE REGISTERED ELECTRIC UTILITY HOLDING COMPANY GROUP

Mr. NICHOLS. Thank you, Senator. I am Guy W. Nichols, president of the New England Electric System and I am here on behalf of that system and on behalf of eight of the nine electric utility holding companies that are registered under the Public Utility Holding Company Act of 1935.

Senator, as you indicated earlier this morning, we have made a great deal of progess in the past year's time. I think we have met the principal concerns of all of the parties involved. I'm sure there is further work to be done and we dedicate our efforts to that end.

In the interest of time, there are three of us here this morning and, with your permission, we will divide up some very brief comments on the three key parts of the act. First, as regards the applicability of the act and exemptions from the act, I would suggest Mr. Lee, president of Duke Power Co., would address that section. Mr. Tankersley will address the diversification areas, and I will comment very briefly on the financing end of the act. With your permission, Mr. Lee.

[The complete statement and response to written questions of Senators D'Amato and Mattingly follow:]

Statement of Introduction

Mr. Chairman, my name is Guy W. Nichols. I am Chairman, President and Chief Executive Officer of the New England Electric System (NEES).[1] I am pleased to appear before the Committee today as part of a panel of gas and electric utility managers to urge Congressional enactment of S. 1174.

On behalf of the panel and the many electric and gas utility companies whose views we represent, I would like to begin by expressing our appreciation for the continued commitment of this Committee and its Chairman to the reconsideration of the Public Utility Holding Company Act of 1935 (the "Holding Company Act" or "the Act"). As managers of utility companies that must conform their corporate activities to the the Act's detailed and complicated regulatory requirements, we fully understand that the legislative task you have undertaken is a trying one.

As you may recall, I appeared before this Committee last year representing the views of the registered electric utility holding companies in support of the initiative of the Securities and Exchange Commission (SEC) to repeal the Act. The testimony of the SEC and others presented in those hearings chronicles the success of the SEC in restructuring the electric and gas utility industries on a financially sound basis.

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[1] New England Electric System is a registered public utility holding company which through its subsidiaries is engaged in the electric utility business in Massachusetts, Rhode Island and New Hampshire.

consistent with the original purposes of the Act. But that task was completed nearly thirty years ago. After reviewing the administrative history of the Act, the development of the Federal securities laws, and the changes in utility regulation since 1935, the SEC concluded that continued Federal regulation of electric and gas utility holding companies is unnecessary and inappropriate. On this basis, the SEC recommended that the Act be repealed.

I personally hold the view, shared by many utility managers, that the the Act should be repealed. This conclusion is not based on a dissatisfaction with the SEC's administration of the Act. It is the experience of registered companies that the SEC has been competent, fair and as flexible as possible within the limits of statutory requirements and the Act's overall policy. However, enlightened administration cannot change the fact that the act is archaic and an unnecessary constraint on management decision making.

We believe that the powers of the SEC under the securities laws -- coupled with the authorities of regulators over the rates, services and financings of public utility companies -- are fully adequate to both protect the interests of consumers and maintain the rationality of a utility company's capital structure. We recognize, however, that credence must also be given to the concerns of utility regulators who fear that elimination of Federal regulation of utility holding companies under the Act could unduly complicate the administration of state regulatory controls.

At the conclusion of last year's hearings, Mr. Chairman, you invited a panel of utility witnesses to devise a proposal to reform the Act in a manner that accomplishes major industry objectives while preserving those aspects of the Act's controls that state regulators and others view as essential to effective utility regulation. The proposals embodied in S. 1174 reflect the industry's efforts to accept your invitation, and to accommodate our objectives to the concerns of state regulators. In developing this proposal, we took instruction from various sources. These include the views of state regulators and utility customers expressed at last year's hearings, the 1982 report of the National Association of Regulatory Utility Commissioners' (NARUC) Ad Hoc Committee on Utility Diversification, and the guidelines for reform of the Act enunciated in the August 1981 resolution of the NARUC Executive Committee. Most importantly, we have placed the proposal before several state regulators to gain their counsel and recommendations. A number of features of the bill are included at their suggestion. While we understand that state regulators may be unable to endorse the bill in every respect, we believe we have, to a substantial degree, accommodated their concerns.

The record developed by the Committee in the last Congress well documents the case that reform of the Act is necessary to modernize its administration, and to relieve undue constraints on the exercise of legitimate business judgment by holding company management. We are confident that this record is a sufficient predicate for substantial regulatory reform. We therefore do not intend to replicate this record in our testimony today. Instead, our statements will be directed specifically to the legislation now before the Committee. We would, of course, be pleased to answer any questions regarding the experience of electric and gas utility holding companies under the Act.

The amendments in S. 1174 affect both registered companies -- that is, companies directly regulated under the Act -- and companies that either are exempt from the Act, or are not subject to it because they have not organized their business activities by use of a holding company structure. Mr. William S. Lee of the Duke Power Co., who is appearing on behalf of a group of exempt holding companies and utility operating companies, will discuss the proposed amendments to the exemptive provisions. Mr. Jack Tankersley of Consolidated Natural Gas Co. will discuss the proposed revisions to the Act's present constraints on diversification as they affect registered holding companies. And, I will address the proposed reform of the Act's controls on registered holding company financial activity.

I would now like to ask you, Mr. Chairman, to recognize Mr. William Lee who will discuss the provisions of S. 1174 which pertain to exempt holding companies.

[Statement of William S. Lee to follow]

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Statement of Guy W. Nichols Regarding Reform of Securities Issuance Controls

Mr. Chairman, I am appearing here today on behalf of eight of the nine registered electric utility holding companies.2/ Together, registered systems provide approximately 20 percent of electricity consumed in the United States.

Like the registered gas companies, registered electric utility holding companies are subject to the most complex array of direct regulatory controls on corporate decision-making now applicable under Federal law. These extraordinary requirements apply to no other sector of American industry.

As I mentioned earlier, I intend to concentrate my prepared testimony primarily on those provisions of S. 1174 that reform the Holding Company Act's controls on utility financing. These provisions, along with the revisions of the Act's constraints on diversification, represent the bill's most extensive reforms. They also contain the most important of the bill's accommodations to the concerns of state regulators, and

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2/ Seven of the nine registered electric utility holding company systems have been actively seeking change in the Holding Company Act. They include American Electric Power Co., Inc., Central & Southwest, Inc., Eastern Utilities Associates, Middle South Utilities, Inc., New England Electric System, Northeast Utilities, and the Southern Co. An eighth company, General Public Utilities, Inc., supports our objectives, and joins in the views expressed here today. In addition the Edison Electric Institute, which represents the views of the electric utility industry as a whole, strongly supports enactment of S. 1174.

therefore deserve the greatest degree of Congressional scrutiny.

S. 1174 also provides relief from a number of other requirements under the Act which over the years have proved particularly troublesome to utility managers. These include modification of the overly restrictive prohibition on appointment to our boards of directors of persons who also serve on boards of certain commercial banking institutions. This prohibition has been a definite and unnecessary obstacle in obtaining the services on our boards of many talented, experienced business people who might otherwise be available.

We have no objection to prohibitions on interlocking directorates if it could be shown that consumer interests are jeopardized. We do not believe, however, that a blanket prohibition, such as presently contained in the Act, can any longer be justified. Accordingly, in place of the current mandatory prohibition, S. 1174 would create new permissive authority in the SEC to prohibit certain interlocking directorates where necessary to safeguard consumer interests.

This reform of the interlocking directorate provision is only one example of the changes in archaic restrictions that would be accomplished by S. 1174. I cannot in this brief presentation fully outline the effect of all of these changes. However, I do want to emphasize that these relatively minor reforms are nevertheless quite important to utility managers.

I would now like to turn to the provisions of S. 1174 which amend the financial controls applicable to registered systems. At last year's hearings, Mr. Floyd W. Lewis of Middle South Utilities explored in some detail the problems faced by registered holding companies in attempting to tailor their financing activities to fit the requirements of the Act. These problems arise primarily from the inflexibility of the regulatory standards to which our securities issues must conform, and the delays and uncertainties associated with the current statutorily mandated procedures for SEC review.

I will deal first with the effect of S. 1174 on the SEC's authority to establish standards for registered company financing. The SEC's authority to prescribe standards governing the types and terms of securities issues is exceptionally broad. While the Federal Energy Regulatory Commission has authority to approve jurisdictional electric utility securities, it does not administer a comprehensive system of limitations and constraints on corporate financings. To my knowledge, the SEC's extensive authority under the Holding Company Act has no precedent -- and no successor -- in Federal law or regulation.

The reasons for granting the SEC this remarkable power to set standards for ordinary private capital raising activities are located wholly in the circumstances of the industry as it existed in 1935. When the Holding Company Act was enacted, the financing of the electric and gas utility industry was largely in the hands of complicated holding company pyramids. Since the Securities Act of 1933 and the Securities Exchange Act of 1934 had only recently been enacted, the sale of securities by these companies had not yet been subject to effective regulation. Investors had no access to reliable information concerning the assets or financial practices of these companies, and no meaningful protection against fraud and misrepresentation. Any legal obligations to shareholders to use prudent business judgment in capitalizing their utility operations were as a practical matter unenforceable. And, the costs of capital ascribed to utility customers was not subject to meaningful regulatory scrutiny. Quite simply, the utility holding companies had no demonstrable motive or incentive, or legal obligation, to develop and adhere to standards of prudent utility financing. The creation of SEC authority to prescribe such standards was therefore perceived as a reasonable legislative solution to a far-reaching and unparalleled economic problem that jeopardized the financial viability of the entire utility industry.

Today, the electric and gas utility industries are subject to the same legal requirements, shareholder responsibilities and market disciplines as those that govern the capital raising activities of all publicly owned corporations. As providers of franchised monopoly service, utility companies are also frequently subject to standards governing capitalization and other aspects of their financing, in addition to those under the Holding Company Act. As a result of the various levels of regulation that now overlay the Act, registered electric utility holding companies find that the requirements and conditions imposed by the SEC on our securities issues do not in any discernible respect improve their investment quality.

I know of no measure of the investment quality of a security other than the judgment of investors, as they are informed by investment advisors and securities rating agencies. Registered companies as a class enjoy no preferred access to available capital by reason of their "special" regulatory status. Indeed, evidence can be marshalled to demonstrate that the great majority of utilities who are free to design the terms of their own securities and access the capital markets without SEC approval actually have an advantage over registered companies in certain circumstances.

In issuing securities, registered companies do not have freedom to select certain types of securities, or to issue securities on terms that the SEC determines are unacceptable. This is true even when terms and conditions of securities that are "unacceptable" to the SEC could actually improve the marketability of an issue. Similarly, the SEC has historically required that public offerings of securities be marketed through competitive bidding. In a stable market competitive bidding can lower capital costs. However, given the volatility that has characterized the market in recent years, a carefully crafted negotiated placement may be preferable and can result in substantial savings. Management should have the flexibility to do so in appropriate circumstances.

Again, the point is that in 1935 there were no industry standards enforced by the rigors of effective securities regulation and market competition. Thus, there was apparent reason for entrusting the SEC with the responsibility to determine which financing tools and underwriting methods were in the public interest. Today, these choices are made in the ordinary course of management decisionmaking. For firms other than registered holding companies, they are within the province of management.

Clearly, registered companies have demonstrated that the Act should be reformed to permit them greater latitude to direct their financial affairs. At the same time, we acknowledge that others believe there is a continuing legitimate public interest to be served in granting the SEC the authorities to shield public utility companies from the effects of financial practices that could imperil their economic well-being.

S. 1174 is a meaningful accommodation of these two principles. It retains in the SEC authority to preclude securities issues that pose an unreasonable economic risk to investors or consumers. Under this standard, practices that would jeopardize the sound financial structure of a utility subsidiary would not be tolerated. However, in evolving standards to determine whether such jeopardy exists the SEC is not permitted to ignore the practices of utility companies not subject to the Act. If, in the experience of unregulated companies, a particular type of financing activity is within the bounds of sound financial management, then it does not pose an unreasonable risk to investors and consumers, and the SEC should not be permitted to preclude its use or change its terms.

This change in the scope of SEC authority is fully consistent with the aims of state regulators in seeking to retain certain aspects of the securities issuance controls. As we understand it, it is not the view of state regulators that the SEC should continue to tell utilities how to finance their operations. Instead, they seek assurance that the SEC will retain the residuum of authority necessary to protect the financial integrity of utility companies.

S. 1174 directly and substantially provides this assurance. Under the bill the SEC would have authority to review securities issues of financial consequence to public utility companies owned by registered holding companies. Such issues include long term debt and significant short term debt by the holding company, and financially significant guaranties and assumptions of liability by the holding company undertaken on behalf of a non-utility subsidiary. Public utility issues would also be subject to SEC scrutiny, unless they are approved by state regulatory authority. Also, as noted above, the SEC would have authority to disapprove an issue if it presented an unreasonable economic risk to utility consumers, as well as to investors.

The elimination of present undue restrictions on management discretion is essential if registered companies are to enter the financial markets on the same footing as exempt companies and utility operating companies. I firmly believe that the substantial reforms proposed in S. 1174 can be accomplished without doing violence to what appears to be the only enduring validity of the Act's financing controls: the protection against improvident encumbrance of utility assets and protection of the capital raising position of utility companies. These remaining securities issuance controls, coupled with other provisions which permit the SEC to restrict extensions of credit and the like, provide ample authority to protect the financial integrity of public utility companies.

The second important aspect of the reforms proposed in S.1174 would accomplish necessary changes in the statutorily prescribed procedures for SEC review of securities issuances. Existing law requires that before a financing decision can take effect, the SEC must affirmatively act to grant its prior permission. Implicit within such a procedure is the view that management cannot be presumed to act in the interests of investors or consumers. I would refer the Committee to my testimony in last year's hearings record. This statement and the testimony of other utility managers illustrates a number of circumstances in which these procedures necessitated costly delays.

The purpose of the proposed changes of the review procedures is to reverse the underlying presumption. Management decisions would be assumed appropriate unless the SEC determines otherwise: that is, after a specified waiting period, a company may go forward with a proposed financing unless the SEC has interceded to preclude the issuance. This relatively simple change accomplishes a great deal for utility managers. Although many financing decisions must still run the regulatory gauntlet, we will have some certainty that within an identifiable period of time, the SEC will indicate to us whether or not we may proceed.

Those of us urging enactment of this legislation fully recognize that the reforms it seeks to effect would in significant respects alter the administration of the Act and reshape its regulatory purposes. However, we believe that such significant changes are a necessary premise for continued Federal regulation of utility holding companies. The Act is based on 48 year old assumptions about the utility industry and the objectives and effect of utility regulation. If the Act is to have any continued vitality, it must be grounded on modern regulatory objectives. We believe that S. 1174, by recasting the Act to give greater deference to state regulators and greater credence to the judgment of utility managers, reflects such objectives and is therefore an appropriate program for reform of the Act.

Thank you for your kind attention. I would be pleased to answer any questions following Mr. Tankersley's statement.

RESPONSE TO QUESTIONS OF SENATOR D'AMATO FROM GUY W. NICHOLS

QUESTION 1:

S. 1174 provides state commissions with a new, federally enforceable right to books and records of non-utility businesses in the U.S. District Court. Shouldn't there be a specific time in which the District Court must act as Commissioner Schuler has testified? The state commission right to the books and records arises in the context of a "pending proceeding". Would you be opposed to modifying this requirement, possibly broadening it?

ANSWER:

The most important and frequently recurring regulatory issues requiring access to nonutility books and records are those involving cost allocations and affiliate transfer prices. These issues inevitably arise in the context of pending rate regulatory proceedings. However, it is obvious that some states view the"pending proceeding" requirement as an impediment to the full use of this information gathering authority. From our perspective such an impediment is wholly unintended and we therefore would not encourage the Congress to adopt the limitation in the face of state commission objection.

However, we cannot support the suggestion that a specific time limit be imposed upon a Federal district court that is hearing a state commission request for information under the section 3A authority. As presently drafted, the statute requires that an action brought under this authority "shall to the greatest extent practicable be expedited by the court and given precedence [over other pending matters] so as to permit the court to render its decision within 60 days from the date such action is brought . . .". Admittedly this statutory time frame is not mandatory. Indeed a mandatory inflexible limitation on the administration of the Federal judicial process would be inappropriate as not within constitutional bounds.

The 60 day time frame is nevertheless compelling legislative instruction to the court that an action to require production of books and records under this section should occur within 60 days. This time frame should be more than adequate for all states, even those whose rate cases are subject to time clocks provided under state law. In extraordinary cases, when due process or other considerations require a longer period for judicial hearing and deliberation, the court would retain sufficient control of its calendar that it could exceed the 60 day time frame. However, even in such a rare instance we believe that no court is likely to defy Congressional instruction and prolong the period in a manner that renders meaningless this legislatively imposed right.

Moreover, it is important to recognize that even in the absence of a mandatory time limit, it is improbable that a company that must return regularly to its rate regulatory forum will intentionally frustrate the proper use of the mechanism establish under section 3A. For these reasons, we are convinced that the 60 day time frame, with its built-in flexibility, strikes a necessary balance between the state commission's requirements and the need to secure for the Federal courts an adequate measure of discretion in the administration of their judicial processes.

QUESTION 2:

S. 1174 provides that exemptions shall be granted upon application and withheld or revoked after there is "clear and convincing evidence" that maintenance of the exemption would "materially adversely affect" the system's public utility business. Shouldn't there be a standard for initially qualifying for an exemption? What criteria should be established for defining "materially adversely affects" and "clear and convincing evidence"? If the SEC is to promulgate such standards, will this require additional manpower?

ANSWER:

As chief executive officer of a registered holding company, I am not particularly well situated to comment upon those provisions of S. 1174 that affect exempt holding companies. I must therefore respectfully defer to the views of William S. Lee of Duke Power Company who has represented the views of exempt holding companies and utility operating companies before this Committee.

The "materially adversely affects" standard does in one instance apply to registered systems. As amended by S. 1174, section 11 of the Holding Company Act would permit the SEC to order divestiture of a non-utility business if it found, on clear and convincing evidence that retention of a nonutility business is likely to materially adversely affect the public utility business of a registered system. The registered electric utility holding companies strongly support the use of this standard. It would be inappropriate to attempt to define in advance the extraordinary factual circumstances in which a non-utility investment could be seen as so substantially threatening to the continued operation of the utility business that management and rate regulatory agencies can no longer perform the task of shielding utility business from the financial consequences of the failed enterprise.

It is entirely consistent with sound legislative policy and the history of the Act to delegate to the SEC broadly defined authority to investigate the circumtances that may require such a divestiture and to pursue that exceptional remedy based wholly on the factual circumstances of a particular case. We also believe the evidentiary standard proposed in S. 1174 is essential to the fair administration of the divestiture authority. Because this remedy is extraordinary and the potential losses to shareholders from such regulatory action is so considerable, we strongly believe that the SEC should not be empowered to order divestiture except where it can make specific factual findings which demonstrate by a preponderance of the evidence that divestiture is justified.

QUESTION 3:

In New York, the legislature mandated that specific Public Service Commission hearings be decided within eleven months. Many states have similar procedural time limits. Dr. Schuler stated (on page 6) that "his staff is adamant in insisting the procedure proposed as Section 3A be shifted from the District Court to a more informal, administrative proceeding within the SEC" because "it is possible that by the time the disputed records are obtained through the Federal District Court the effective use of that information would have been mooted because of the state imposed time clock." Would you please comment on Dr. Schuler's concern?

ANSWER:

As discussed in the answer to question 1 above, it is our position that the 60 day time frame established in S. 1174 is fully adequate to ensure that state commissions will have ample time to gain access to and review any nonutility books, records and accounts under the section 3A authority. We do not believe that the creation of an SEC procedure meaningfully enhances the usefulness of this authority to the state commissions. First, only a handful of state commissions are within the geographical proximity of Washington D. C. For most states, the expense of resources required to participate in even an "informal" SEC proceeding would render meaningless this right of access. For all but a few states, the district court is a far more accessible, and thus preferable, mechanism.

Moreover, it is by no means clear that an administrative path would be more expeditious. Even in an "informal" proceeding, the SEC would be subject to some minimal requirement for notice and an opportunity for comment on the part of the company that is the subject of the proceeding. Furthermore, if the Commission's order should be appealed, it would result in further delay.

Finally, section 3A would be applicable to exempt holding companies, which are not otherwise subject to SEC administrative authority under the Act. There is little justification for making those companies subject to a Federal administrative authority in this limited respect when a local judicial forum can more efficiently and less expensively enforce the right of access granted under Section 3A.

QUESTION 4:

Dr. Schuler suggests that the requirement that information requests under proposed Amendment 3A originate from an ongoing proceeding has a Catch-22 quality. The reason being that all too frequently these information requests are used to form the basis for initiating a proceeding. Is this "theory" consistent with your experience?

ANSWER:

I have no experience that documents the claim that state commissions have had to acquire books, records and accounts of a holding company's nonutility businesses in order to initiate an inquiry concerning utility rates or service. With respect to inquiries into utility performance of its service obligations, I must point out that the electric utility industry as a whole enjoys an excellent record in meeting its lawfully established service obligations. As a result, investigations of possible lapses in the performance of these obligations are quire rare. I am not personally aware of any case in which a state commission has suggested that an electric utility's diversified enterprises have impaired the quality of utility service. Even if such a case should arise, I know of no circumstance in which a detailed inquiry into affiliated non-utility books and records would be a necessary predicate to the initiation of such a proceeding.

Because proceedings regarding utility service are so uncommon, the only recurring issues that commissions may face requiring access to books and records concern customer charges. These issues inevitably arise in the context of a rate proceeding in which, for example, the FERC or the state commission is allocating costs between utility and non-utility businesses or deciding issues related to the passthrough by utilities of amounts paid to affiliated suppliers of goods and services.

As I stated in the answer to Question 1 above, I have no experience and know of no circumstance which evidences that the "pending proceeding" requirement in S. 1174 would work to frustrate state commission use of the authority under section 3A. However, if the state commissioners are persuaded such circumstances exist, we do not object to the elimination of that provision.

QUESTION 5:

In connection with utility diversification, you identify the antitrust laws as the instrument to address the concerns raised by the previous panel of contractors. Within your experience, have the antitrust laws ever been applied to any instance of utility diversification?

Are the antitrust laws alone an adequate safeguard to protect consumers and competitors from exploitation?

Would you object to allowing some role for the Justice Department's Antitrust Division in the consideration and approval of applications for utility diversification?

ANSWER:

While I have no direct experience which bears on this question, I understand that the Federal antitrust laws clearly apply to utility companies in the conduct of their nonutility business activities.

It is not our objective in diversifying to enter nonutility markets on the strength of an unfair advantage subsidized by ratepayers. And, we believe that upon examining the combined effect of the anti-trust laws and utility rate regulation, the Committee will find that there is a fully adequate array of remedies to any anticompetitive practices that may result from utility diversification.

First, the primary protection for ratepayers against cross-subsidization is the rate regulatory process. If costs are properly allocated between utility and non-utility enterprises, it cannot reasonably be maintained that the utility customers are subsidizing the non-utility businesses. To enhance the efficiency of the cost allocation process, and to provide unregulated businesses with greater confidence in the resources and ability of state regulators to make accurate cost allocations, we fully support the creation of a new, Federally enforceable right of access to nonutility books and records, as provided in S. 1174.

Moreover, the protections inherent in the rate regulatory process exist in addition to the prohibitions and enforcement devices available under both the Federal antitrust statutes and their state law analogues. These laws impose criminal and civil penalties for violation of prohibitions on anti-competitive and unfair trade practices. A well developed, and ever growing body of administrative and judicial case law defines the full breadth of these prohibitions. The laws also create a substantial array of legal remedies to such practices including consent decrees, "cease and desist" orders, injunctions and other enforcement mechanisms.

As stated above, regulated utilites clearly are not exempt from these laws with respect to their nonutility activites, and indeed may be subject to more careful scrutiny than an unregulated enterprise. For example, the head of the Justice Department's antitrust division in testimony before the subcommittee last year made clear that the Justice Department will scrupulously enforce the antitrust laws when utilities diversify into vertically integrated business lines, even though the Department's policy is not to oppose vertical integration of nonutility businesses. For these reasons, we believe that any potential danger to competition posed by utility diversification is adequately contained by state and federal utility regulation and antitrust laws.

QUESTION 6:

It has been said that utility ventures into traditional wholesale, retail and contracting functions are often subsidized by passing through part of the cost to their rate payers. Is this a fair assessment of utility practices?

ANSWER:

From my experience, I known that when a utility engages in any business of this sort, the strictest attention is given to the allocation of cost to make certain that cross-subsidization has not occurred. The reason we do this is that we know that in a rate proceeding, this allocation will be scrupulously reviewed.

RESPONSE TO QUESTIONS OF SENATOR MATTINGLY FROM GUY W. NICHOLS

I. Reform of Securities Issuance and Financing Controls

QUESTION:

I understand that one of the major reasons for enacting the Holding Company Act was to give the SEC the full range of authorities necessary to prevent the fraudulent and abusive investment practices of holding companies, which had undermined the financial soundness of the utility companies they controlled. Can Congress be confident that if S. 1174 is enacted the financial integrity of utility companies will not be jeopardized?

ANSWER:

Yes. In contrast to the circumstances in 1935, utilities today are extensively regulated by state and federal authorities. These regulatory agencies control our rates and supervise the performance of our service obligations. Moreover, the development and modern administration of the traditional forms of securities regulation applicable to all publically traded companies effectively preclude a recurrence of the financial abuses of the early part of this century.

We recognize nevertheless that state regulators and others remain persuaded that SEC review should be maintained to the extent necessary to protect the public utility businesses of registered systems. This is precisely what S. 1174 seeks to achieve. It retains SEC authority to review financings that can be of consequence to the utility subsidiaries. The SEC could still intercede to prevent securities issuances that would pose an unreasonable economic risk to investors or consumers. This presents a meaningful accommodation of the needs of utility managers for greater flexibility and the wishes of state regulators that the SEC retain authority necessary to prevent the unreasonable encumbrance of utility assets or the impairment of creditworthiness of our utility subsidiaries.

QUESTION:

Under the reforms proposed in the bill the SEC may disapprove an issuance if it finds it involves unreasonable economic risk to investors or consumers. How will the SEC determine what constitutes such a risk?

ANSWER:

The experience of companies not presently subject to SEC scrutiny demonstrates that there are various financial practices not available to registered systems that do not present an unreasonable risk to the investors or customers of the companies. S. 1174 would require the SEC to take this experience into account before interceding to preclude financial practices which may present unusual risks to investors or consumers.

Actually we would not expect the SEC to ever have occasion to use this authority. There is every reason to believe that management will act in a manner consonant with the interest of their shareholders and the customers of their utility operations. But should that assumption prove to be invalid, the SEC would have residual authority which would allow it to step in to protect investors or consumers.

QUESTION:

The amendments in S. 1174 appear to be designed in large part to protect the interests of utility consumers. If the bill were passed should the authorities under the Act be transferred to the Federal Energy Regulatory Commission, which has responsibility for federal public utility regulation?

ANSWER:

We believe very strongly that the SEC should continue to administer the Act. The SEC's familiarity with the Act is essential to insure the efficient administration of this very complex statute.

Moreover, the authorities left in place by S. 1174 would still apply to inter- and intra-company financial arrangements. Given its experience in administering the Act, and in regulating such financial transactions within a registered holding company system, the SEC remains better equipped than any other agency to administer the Act's remaining regulatory controls.

QUESTION:

S. 1174 permits the SEC 20 days to review a securities issuance. Is this sufficient time in which to ensure that a proposed financing will not present an unreasonable risk to investors or consumers?

ANSWER:

The 20-day review period is an important and necessary element of the regulatory reforms proposed in S. 1174. Under present law, the SEC exercises "command control" authority over our financing activities. This means that when management decides that capital must be raised to finance its business, and then selects an appropriate financing vehicle, it cannot implement its decision unless and until such time as the SEC gives its approval. Under S. 1174, much of this uncertainty will be eliminated, by revising current procedure to lay financing decisions before the SEC for a time certain. Within 20 days, management will know whether it may go forward or whether further review procedures are required.

In this respect, it is not quite accurate to view S. 1174 as imposing an absolute 20-day limit on SEC action. If the company seeks approval of a financing plan, a state commission may, upon request, be granted an automatic 20-day extension of the review period. Also, when a proposed financing does present a problem, the SEC is only required within 20 days to issue a preliminary order disapproving the plan or requiring that certain terms and conditions be met. We expect that this preliminary order would be an invitation to further discussions with the SEC to find a way to reshape the financing to cure its objectional features, or to withdraw it. There is no time limit on this process, except that the SEC must issue a final order within a reasonable time.

We believe this type of procedure substantially relieves us of the regulatory uncertainty and delay that can trouble our current financial planning, while permitting the SEC the flexibility necessary to discharge its regulatory responsibilities.

QUESTION:

Apart from the review of individual securities issuances, the Act contains a number of other controls on intercompany financing that would be substantially reformed under this bill. Do the reforms to the other provisions expose the public utility companies to misuse of their assets or capital or the imposition of cost of non-utility businesses on public utility subsidiary customers?

ANSWER:

The other financial controls in the Act are included in Section 12. It is true that S. 1174 modifies them, in order to tailor their purposes more directly to protection of financial integrity of public utility companies. However, the controls that remain are quite substantial. The SEC can still impose restrictions on extensions of credit by utility companies to any other company in the system. The SEC could also impose limitations on the declaration of dividends that are necessary to safeguard the public utility company. Certainly in NEES' case these controls are more extensive than any applicable under state law, and we believe in all cases are far more than would actually prove to be necessary to adequately protect utility assets and credit.

QUESTION:

If the controls embodied in S. 1174 were enacted, what will prevent a recurrence of the self-dealing financial practices that endangered the electric utility industry prior to 1935?

ANSWER:

The primary protections against a recurrence of self-dealing financial practices are the Federal securites laws which require full and continuous public disclosure of corporate financial activities. These laws are buttressed by uniform accounting rules, standards of professional practices, and the disciplines of the securities market. Also the SEC has vigorously and effectively enforced the law to prevent fraud and misrepresentation.

Moreover S. 1174 would leave in place a number of additional safeguards with respect to registered companies as a final assurance that the financial integrity of the utility company subsidiaries can be safeguarded.

II. Reform of Controls on Diversification

QUESTION:

From the testimony presented last year, it is clear that very few people object to modification of the Act's controls on securities to permit management greater discretion to make financing decisions. The most controversial aspect of S. 1174 is that it also eliminates provisions of the Act which now constrain utility diversification. Why should Congress amend the Act to permit utility diversification?

ANSWER:

It is important to recognize that the Holding Company Act does not now operate to prohibit diversification, even for registered companies. Diversification for some utility companies is already a fact of corporate life. In 1981 the Edison Electric Institute surveyed its member companies to discover the extent of diversification in the electric utility industry. EEI found that among 125 electric utility companies involved in the survey, 63 percent were engaged in at least one business venture outside their utility businesses.

S. 1174 will eliminate certain provisions of the Act which have been interpreted as confining registered company diversification to those activities which are functionally related to the holding company system's operations. And, the bill would take the SEC out of the day to day business of supervising this non-utility business.

With these constraints eliminated it is possible that some utilities will initiate a diversification program or undertake further non-utility investments. So, it is not inappropriate for Congress to inquire into the benefits and risk of utility diversification.

Utilities are drawn to non-utility investments by the same potential benefits that attract unregulated firms. Diversification has for many years been recognized by financial analysts as a means to diversify business risk, stabilize overall earnings patterns, make use of financial synergies, and lower the firm's overall costs of capital. Utilities also have frequently undertaken fuel supply ventures to secure a firm, reasonably priced sources of fuel. We believe that the initial experience of electric utility companies in non-utility lines of business demonstrates that diversification is a sound business planning device which can improve the overall financial profile of a utility company. It is not a panacea and not all utility companies will (or should) pursue diversified enterprise, but we firmly believe that it is an option that management should have more flexibly available to it, should it make the reasoned and reasonable corporate decision to diversify operations.

QUESTION:

If utilities may diversify under present law, why do the Act's regulatory controls need to be revised?

ANSWER:

Although registered companies have been permitted to diversify, there are provisions of the Act which have been interpreted to preclude us from entering certain potentially profitable lines of business. Registered companies are today limited to activities that are "functionally related" to the utility business. The SEC has considerable (albeit not unlimited) discretion to determine what is or is not functionally related. Although the rule is much more broadly construed than in the early years of SEC administration of the Act, there is no way to anticipate how far we can go, or whether the SEC will change its mind and at some future time constrict its view of what meets the test. Moreover, even when the test is read broadly, there are opportunities to put excess capacity to use in non-utility businesses that would likely not qualify.

The other significant problem for registered companies is the requirement for prior SEC approval of all non-utility investment. Frequently, non-utility firms are very reluctant co-venturers with registered holding companies. They are simply unwilling to immobilize their assets pending SEC review of a proposed investment. In other cases, such as the oil and gas leasing business, opportunities will evaporate if a firm is unable to respond quickly. While the SEC has in many cases attempted to expedite its procedures, there inevitably are business opportunities we must by-pass recognizing that the review procedures will complicate the timing or frustrate a non-utility partner. So long as we are required to submit each non-utility investment decision to the SEC, we will bear the costs of these lost opportunities -- costs that are not borne by exempt and operating companies undertaking the same types of non-utility enterprises.

QUESTION:

Under present law the SEC approves each diversified investment undertaken by a registered holding company. S. 1174 eliminates this authority, and requires only that a company file a diversification plan describing its future non-utility investment prospects. Is this requirement sufficient to give customers confidence that their interests are being protected?

ANSWER:

Like the Act's other requirements, the controls on diversification prevent management from taking any steps unless and until the SEC gives its blessing. As the witnesses before the Committee have explained, these kinds of procedures can be very costly to companies entering unregulated and highly competitive businesses.

Over the last few years, state regulators and others have studied problems presented in regulating diversified utilities. Although regulatory questions have been identified -- such as cost allocation and transfer pricing issues -- there has emerged little support for the view that regulators should supervise the individual investment decisions of utility management. The NARUC Ad Hoc Committee on Utility Diversification has cautioned regulators to be wary of assuming responsibility for what are most appropriately management decisions. The Ad Hoc Committee recommended that a means be devised which permits regulators to monitor the pace of diversification, and indeed suggested that an appropriate device to implement this would be to require periodic regulatory review of diversification plans.

We believe that S. 1174 represents a reasonable accomodation of management need for regulatory flexibility and the regulatory objective of ensuring that a diversification program be pursued at a measured pace and in a prudent manner. We believe that management should be permitted to undertake some amount of diversified investment without regulatory scrutiny -- to establish a track record that builds the confidence of regulators and customers. We recognize that as the amount of diversification in relation to the overall size of the firm becomes significant, regulators will want an opportunity to anticipate the nature and extent of further diversification plans. S. 1174 requires this, and provides that if the activities contemplated in such a plan are likely to result in unreasonable costs or impair utility service, the SEC could prevent the utility from undertaking these activities. We believe this provides ample authority to permit the SEC to halt a diversification program that endangers the utility business and its customers, while providing a much needed modern and flexible approach to federal regulation of utility diversification.

QUESTION:

Utilities have made a persuasive case that successful diversification can benefit utility investors by increasing the firm's profitability, and can benefit utility customers by lowering capital costs to the consolidated enterprise. But how can utility customers be assured that they won't be required to assume the costs and risks of diversification out of proportion to any expected or possible benefit?

ANSWER:

For the vast majority of the electric and gas utility companies, the responsiblity for ensuring that utility customers do not bear the costs of non-utility enterprises lies with state regulatory agencies and the FERC. These agencies establish the rates for utility service, and in doing so supervise the prices paid to non-utility subsidiaries in affiliate transactions. They also review cost allocations to ensure that costs of the non-utility enterprise, including capital costs, are not improperly borne by the utility ratepayer.

We recognize that if diversification increases state regulators may face these rate regulatory tasks with greater frequency. We believe that the use of a holding company structure eases this task, by facilitating the efficient segregation of utility and non-utility books, records and accounts. However, we understand that state regulators have concerns that they may be deprived of access to books, records and accounts of non-jurisdictional companies that are necessary to set affiliate transfer prices or make accurate cost allocations. Quite frankly, it is the experience of registered electric utility holding companies that state commissions are fully equipped with all necessary information gathering powers. And, the SEC has extensive authority to set uniform systems of accounts and to gain complete access to our books and records, on a sytemwide basis. Nevertheless, it is not our purpose to complicate the already difficult task of state regulators. For that reason we will not oppose the provisions in S. 1174 which create for state commissions a new, federally enforceable right of access to non-utility books and records, if such access is necessary to the performance of their regulatory responsibilities. In addition to complying with state and FERC requirements, registered companies would remain subject to provisions of the Holding Company Act that require the SEC to supervise cost allocation and prices paid in affiliate transactions.

QUESTION:

S. 1174 contains a provision that would permit affiliate transfer prices to exceed costs plus a reasonable rate of return. Why should the SEC be permitted to authorize such higher prices?

ANSWER:

The "cost standard" under section 13 of the Act grants the SEC little flexibility in determining prices that may be paid in transactions between companies in the same holding company system. It requires that all such prices be limited to the selling company's "cost" which the SEC has determined is cost plus a utility allowed rate of return. The SEC may permit variations in "exceptional circumstances," but such authorization is difficult to obtain, and only after a lengthy procedure.

The cost standard is another illustration of a provision which was important to the Act's original purposes, but which is no longer valid today. In the modern business and regulatory context, there are many circumstances in which it is preferable from the perspective of both investors and consumers to permit transfer prices above cost. In such cases, use of a market-referenced, rather than cost-based, price is simply good regulatory policy. Recently, the Federal Energy Regulatory Commission permitted a utility to set an affiliate coal transfer price at the market rate. Its reason for doing so was primarily that a market referenced price insures that utility investors, not customers, would bear the risks if the costs of production exceeds the price at which the utility could acquire coal from an independent supplier.

S. 1174 does not represent a wholesale abrogation of the cost standard. It merely permits the SEC, on a case-by-case basis, to permit a variation from the cost standard, up to the market price of the goods or services being provided, when doing so would serve the interests of investors or consumers. Such change is reasonable, necessary, and fully in line with modern rate regulatory practice.

QUESTION:

Will diversification distract the attention of utility managers from the business of providing reasonably priced and reliable utility service? Will the successfully diversified utility company simply spin-off a utility subsidiary, if it gets into financial trouble?

ANSWER:

We believe that diversification will enhance the quality of the management of utility companies, not detract from it. Diversification has made utilities more attractive and better able to hire and keep talented, capable management personnel. And, experience gained in meeting the challenges of managing nonutility business can enhance the performance of utility managers. Innovative ideas developed in the nonutility sectors of the firm may frequently prove useful in areas such as investment, financial management and marketing of utility services.

Moreover, Congress must also recognize that even a diversified utility company or system is significantly dependent upon the financial performance of the utility business to maintain its overall profitability. We take very seriously our obligation to our customers and investors to devote all of the management attention and skills necessary to insure that we will provide reliable utility service at reasonable costs.

I should emphasize that many electric utility managers have no interest in diversification. Among those who do contemplate diversified investment, I know of none who believe that it would detract from their attention to their utility operations.

Moreover, even if diversification were substantial, there would still be no incentive to spin-off a utility company business unless that company's earnings fall below that necessary to permit the recovery of the operating and capital costs associated with utility investment. Thus, so long as utility rates are adequate to cover the costs of the utility business, these companies will be a vital part of even the most broadly diversified firm.

QUESTION:

How can the interests of consumers be protected if a utility experiences a substantial failure in its nonutility business activities?

ANSWER:

First, it is important to recognize that utility diversification of necessity will proceed at a measured pace. Most utilities simply lack the capital resources to deploy a significant portion of their assets into nonutility lines of business within short periods of time. Undoubtedly, there will be losses and successes. However, with diversification proceeding incrementally, it is extraordinarily unlikely that the company would experience a sudden "colossal failure" of all of its nonutility ventures.

We recognize, however, that utility companies provide an essential service, and that regulators will insist upon additional assurance that the SEC be authorized to intervene if necessary to protect against the adverse effects of improvident diversification. For that reason, we do not object to the inclusion in S. 1174 of a provision which retains SEC authority to order divestiture of a failing nonutility enterprise. If the SEC finds that such venture "materially adversely affects" the public utility business, it could order divestiture. We believe that this authority, coupled with the periodic review of diversification plans, provides ample assurance that customers will be shielded from the risks and losses of nonutility enterprises.

III. Other Provisions

QUESTION:

Last year, those opposing repeal of the Act expressed concern that utilities would be vulnerable to takeovers by firms with no experience or interest in maintaining the quality of utility service. Does S. 1174 contain any provisions that would prevent that result?

ANSWER:

S. 1174 both retains current provisions of the Holding Company Act that would constrain such takeovers, and actually imposes further controls that would strengthen the restraints on corporate takeovers now embodied in the Holding Company Act. For registered systems, the Act would remain unchanged: the SEC would still have to review any acquisition by a registered company of another utility company's securities. With respect to other utility companies, the Act would also retain existing provisions which prohibit combinations of utility companies, unless the SEC determines the combination is in the public interest.

In addition, S. 1174 would add a new provision that fills a gap in existing law. Presently, the anti-takeover provisions apply only in the case of combinations, i.e., a company that owns one utility company is precluded from acquiring another utility without SEC approval. This does not, however, prevent a company that is not affiliated with a utility from taking over a single public utility company. In such a case, no SEC approval is required. S. 1174 would increase the SEC's authority to prevent hostile takeovers that would not be in the public interest, by bringing such acquisitions of a single utility company under SEC scrutiny.

QUESTION:

Representatives from plumbing, heating, and electrical contracting associations have indicated that utility vertical integration into conservation, air conditioning and related businesses has been accompanied by anticompetitive practices which have adversely affected their businesses. They claim that utility ratepayers are being forced to cross subsidize the nonutility business activities. How does the utility industry respond to their concerns?

ANSWER:

We are extremely concerned with the claims that electric utilities have entered certain nonutility businesses on a basis which is anticompetitive and unfair to small businesses. As a general rule, we believe all parties would agree that regulated utility companies should not be able or allowed to subsidize diversified enterprises at ratepayer's expense. And we believe that small businesses should protest any circumstances in which ratepayers may be asked to bear the costs of nonutility enterprise to the detriment of competitive market conditions.

However, we cannot agree that there are no adequate means available to detect and prevent cross-subsidization. Proper allocation of costs, including capital costs, between utility and nonutility businesses will ensure that nonutility ventures will bear the cost of doing business in an unregulated marketplace. There exists ample authority under state and Federal rate regulatory law to accomplish these cost allocations and to eliminate any unfair advantage. Moreover, S. 1174 strengthens the authority of state commissions to insure that proper cost allocations are made, by providing a right of access to books, records and accounts of nonutility businesses of both registered and exempt holding companies.

I must emphasize that to a great extent the problems of small businesses are not problems that are either created or solved by the Holding Company Act. The problems experienced by these companies occurred with the full range of the Act's authorities in place. While I do not know of the circumstances that have led to the objections of these contractors to utility diversification, I do know the utility companies want only the opportunity to enter unregulated businesses on a competitive basis. If small business contractors can demonstrate that further changes in the Act can usefully safeguard against cross-subsidization without directly prohibiting our participation in non-utility businesses on a fully competitive basis, we would consider supporting them.

QUESTION:

It appears to me that the record established last year clearly demonstrates that the Act is no longer necessary or appropriate and should be repealed. Why should this Committee support a lesser solution to the problem?

ANSWER:

As I noted in my formal remarks before the Subcommittee, I share the view that the Act should be repealed. I believe that Congress could take that action fully confident that Federal securities laws and state and federal rate regulation are more than adequate to protect investor and consumer interests. However, we recognize that state regulators and others do not share that confidence and oppose repeal. We therefore support S. 1174 as a means for gaining relief from the regulatory burdens imposed under the Act, in a manner which substantially accommodates the objectives of state regulators.

STATEMENT OF WILLIAM S. LEE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, DUKE POWER CO., CHARLOTTE, N.C.

Mr. LEE. Mr. Chairman, my name is William S. Lee and I'm chairman and chief executive officer of the Duke Power Co., an independent electric operating company that serves about half of the people in North Carolina and about half the people in South Carolina. We are not now subject to the Public Utility Holding Company Act of 1935. I am also representing an ad hoc group of over 25 electric and combination gas and electric and gas utilities that have an interest in reform of the Holding Company Act. Some of these companies are presently exempt holding companies under the Holding Company Act, while others, like Duke Power, are not now subject to the act but are considering activities that could subject them to the act or that could be affected by this reform of the act.

REGULATORY UNCERTAINTIES

I'd like to focus on the regulatory uncertainties that the Holding Company Act creates for exempt companies and on the unnecessary obstacles that it erects for the many independent operating companies throughout the country like Duke where if the Holding Company Act were reformed we could consider the formation of holding companies as an optimum corporate structure to use for the full and most economically efficient deployment of our assets and service to our customers.

Our corporate objective is and will continue to be to excell as an electric utility, to provide high quality electric service to our customers at affordable prices, and at the same time earn a compensatory return for our investors.

Now this won't change. For some time now our management has considered however the formation of a holding company as one measure of our long-term corporate strategy. Unfortunately, since we have material utility operations in both Carolinas, the two States, we would have to register as a registered holding company since we would not qualify for any of the exemptions presently contained in section 3 of the act.

We are most affected—Duke is and the group I represent—by section 4 of the proposed bill which provides that exemptions should be available without qualification to holding companies whose structure and public utility operation are confined within specific geographic limitations, essentially one public utility subsidiary confined to contiguous States.

This is designed to insure effective State regulation of the public utility business. The bill does not change the current law under which a company is procedurally granted an exemption if it does business within the specific geographic limitation contained in section 3 and it files for an exemption in good faith.

A second major provision of the bill is the one that modifies the regulatory mechanism by which an exemption may be withheld, conditioned, or revoked, modification of the so-called unless and except clause. Modification of the unless and except clause as set forth in S. 1174 is needed because the SEC presently has extremely broad authority to condition or revoke retroactively a statutory exemption, the consequences of which are very severe indeed.

Many companies, including presently exempt holding companies, are simply unwilling to commit material assets to nonutility businesses if they risk the retroactive loss of their exemption or the forced fire sale divestiture of such assets in order to hold the exemption.

Thus, the use of a holding company structure which I believe serves the best interest of both investors and consumers and in my view the contractors you heard from today, is clearly being discouraged by the present Holding Company Act.

It's important to remember, sir, that for independent operating utilities like Duke the issue is not diversification. We are diversified today and have been since 1910.

Senator D'AMATO. Would you address that issue in terms of diversification and give us some examples of things that you've done?

Mr. LEE. Very well, sir. We sell through a subsidiary electrical equipment and wires and switches and motors and transformers to the contractors like you heard from this morning. They are valued customers. We compete with GE, Graybar, and Westinghouse. We sell hot water heaters and have longer than I've lived, and that requires a plumber and an electrician to hook up the hot water heater in the home. We stay out of the basements.

Senator D'AMATO. You provide the hot water heater, do you also do the contracting work yourself?

Mr. LEE. We do not install it. We give our customer who wants to buy a hot water heater a list of the members of the local plumbers, contractors association, and the NECA members, National Electrical Contractors members.

Senator D'AMATO. How does that work?

Mr. LEE. Fine. We have been doing it longer than I've lived.

Senator D'AMATO. Should we require this of the utilities? I put it to all of you to consider as a method for dealing with this ongoing problem. Cross subsidization is a legitimate concern and one that by the way could sidetrack some meaningful reform. So I leave it to you to think about. I don't need a binding commitment now, but it certainly seems to me that a good number of the contractors might come forward in the small business community and say, boy, this is terrific, S. 1174 does the job, that is if something like that could be worked out.

Mr. LEE. Well, I have talked to contractors in our service area about S. 1174. On the basis of my representation about S. 1174, they see no problem in the businesses that we have been doing for years.

Senator D'AMATO. Do you want to touch on any others? I find this interesting. Here you are marketing the electrical equipment, the hot water heater, but you have refrained from installation by your use of the association's listings.

Mr. LEE. S. 1174 gives them protection they don't now have.

Senator D'AMATO. Well, it might if we do some of these things.

Mr. LEE. If you do some of these things. If our company comes in for an exemption under the act, S. 1174 would clearly separate the utility business from the diversified businesses. It would separate the books, the accounts, the assets, enable the State commissions to have access to those books and accounts to make sure that there is no subsidy from the utility side to the diversified side. This does not now exist without S. 1174 in our case because we do not have a utility held by a holding company and these other outfits held by a holding company.

Senator D'AMATO. So your State regulatory agency cannot come in and look at the books of some of your other operations?

Mr. LEE. Mr. Chairman, one of the provisions of S. 1174 is to give the State commissions access through the Federal courts to the books. I'm speaking from experience, sir. It would be foolhardy of me to insist they go that channel. They look at my books today of the diversified subsidiary to make sure that there's no subsidy and I don't want to make them angry by saying, no, you can't have the books until you go to Federal court. That's a stopgap measure that ought to be in the bill, but I can't visualize ever employing that. If the contractors in our area have a problem, I hope we can work it out. If not, they can go to the State commission and they say "Expose," and we expose. That's the way that would work.

So the important issue here for an outfit like Duke is not the matter of diversification, but what is the optimum corporate structure in the interest of our ratepayers, of our diversified businesses, of our investors, and what is the optimum corporate structure in the interest of our nonutility competition? We think S. 1174 is in their interest. Here's why the two changes that I've mentioned are important to us, to our electric consumers, to our investors, and also to the contractors that you've heard from.

IMPORTANT CHANGES

First, it will facilitate State regulation of the utility business to make sure the demarcation is there. It will minimize the possibility of any losses or liabilities to the utility and to its ratepayers from these other businesses. It will prevent cross-subsidization and it will facilitate the raising of capital on more reasonable terms, therefore benefiting the ratepayers, we believe.

I mentioned it's important to assure the State regulators of access to the books and there is that safeguard provision in S. 1174. Duke Power hopefully will never have to use that because we are in bad trouble if we ever do.

Section 5 also empowers the SEC to require the reports of nonutility activities of both exempt and registered systems. Now we are neither exempt nor registered right now and State regulators are expressly provided the opportunity to apply to the SEC to require such reporting.

In my opinion, the best way to prevent cross-subsidization is through effective State regulation of the utility business and give us the freedom to organize ourselves with a clear demarcation between the utility business and these diversified businesses.

The holding company structure offers the cleanest, clearest, most distinct separation of the utility and nonutility assets and I think will contribute to the solution of some of the problems reported to this committee by the contractors. It will facilitate the regulation of affiliate transactions and minimize that cross-subsidization process.

In the hearings last year it was clearly established that proposals for repeal of the Holding Company Act were not a source of the contractors' problems, but, rather, that the residential conservation service and commercial and apartment conservation service were. There is, in fact, no Federal prohibition against diversification by utilities that are not registered holding companies and even registered systems which are restricted to functionally related diversification can presently diversify to any conservation or electrical contracting work.

Another aspect of S. 1174 that merits specific discussion is the fact that Federal and State regulators have sufficient authority under existing law to regulate any potential utility combinations that may be inconsisent with the public interest. I certainly want to point out that the original restrictions contained in the Holding Company Act on utility mergers and acquisitions have been strengthened by the provisions in S. 1174 providing the SEC with effective power to prevent nonutility enterprises from superimposing themselves upon the public utility.

Mr. Chairman, I respectfully submit and urge that this subcommittee proceed to remove the unnecessary regulatory burden that the Holding Company Act imposes on the electric and gas utility industry by supporting the quick passage of S. 1174. Largely due to your leadership, Mr. Chairman, because last year you heard diversified opinions from different utility groups and we've all gone back to the drawing boards and we have all compromised, and we thank you for your leadership. We now think there's a thoughtful and well reasoned regulatory reform package. It's a far cry from the repeal of the entire act. This bill is not what any one of us would rather have in detail, we have compromised significantly in supporting the legislation. We think it's in the public interest. I think it's in the contractors' interest, and my experience in the diversified business in all my life says that's so.

I think we would urge that others also support this bill. Thank you for letting me testify. Now Mr. Nichols is going to call on Mr. Tankersley.

[The complete statement follows:]

STATEMENT OF

WILLIAM S. LEE
CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER
DUKE POWER COMPANY

SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 14, 1983

Mr. Chairman, members of the Subcommittee, I very much appreciate the opportunity to testify before you today on this important issue affecting our Nation's electric and gas utilities. My name is William S. Lee, and I am Chairman of the Board and Chief Executive Officer of Duke Power Company, an independent operating company providing electric service in the central portion of North Carolina and the western portion of South Carolina. Duke Power Company is the ninth largest investor-owned utility in the United States in terms of kilowatt-hour sales and is not now subject to the Public Utility Holding Company Act of 1935.

I am also representing an ad hoc group of over 25 electric, combination gas and electric, and gas utilities that have an interest in reform of the Holding Company Act. Some of these companies are presently exempt holding companies under the Holding Company Act, while others, like Duke, are not now subject to the Act but are considering activities that could subject them to the Act or that could be affected by reform of the Act.

Mr. Chairman, our group believes that S.1174, the legislation that you and Senator Johnston introduced, provides meaningful reform of the Holding Company Act while preserving the necessary protections that it affords investors and consumers.

In the last Congress, under your leadership, hearings were held before this Committee and the House Energy and Commmerce Committee. Based on the extensive record that was established during those hearings, it was demonstrated beyond question that there was a real need to reform and modify this 48 year-old statute. Rather than restate the testimony provided last year, I would prefer to discuss in some detail the regulatory uncertainties that the Holding Company Act creates for exempt companies and the unnecessary obstacles that it erects for the many independent operating companies throughout the country, like Duke, that, if the Holding Company Act were reformed, would consider the formation of holding companies as the optimum corporate structure to use for the full and most economically efficient deployment of their assets and service to their customers.

Mr. Chairman, at the very outset of my testimony, I think it important to restate for the Subcommittee a point that Bill Grigg, Executive Vice President of Duke Power Company, made during the hearings last year. Duke Power Company's major corporate objective is, and will continue to be, to excel as an electric utility -- to provide high quality electric service to consumers at affordable prices while at the same time earning a compensatory return for its investors. This will not change. For some time now, however, the management of Duke has considered the formation of a holding company as one measure of our long-term corporate strategy for the maximum and most economically efficient utilization of our company's existing utility and non-utility assets. Unfortunately, since Duke has material utility operations in both Carolinas, we would have to register as a registered holding company since we would not qualify for any of the exemptions presently contained in Section 3 of the Act. In view of the unreasonable burdens the Act places on registered companies, as you will shortly hear, and the uncertainties faced by exempt companies, Duke Power simply would not form a holding company under these circumstances. Other companies face a similar problem if they have a public utility subsidiary organized and operating in another state.

As a result, Duke is most affected by Section 4 of S.1174 which amends Section 3 of the Holding Company

Act. I think it is quite significant, in view of certain aspects of the legislative history that I will discuss later, that the proposed legislation provides that exemptions should be available without qualification to holding companies whose structure and public utility operations are confined within specific geographic limitations designed to ensure effective state regulation of the public utility business. In this regard, I am especially supportive of that paragraph in S.1174 which slightly broadens the Act's original exemptive provisions by providing that a company, like Duke, whose public utility operations are confined to two contiguous states could form a holding company over such operations and still gain exemption from the Act. This exemption is, in my judgment, properly qualified by virtue of the fact that in order to come within its terms, such holding company may have only one public utility subsidiary. Such subsidiary may, of course, consistent with interpretations of the present law, be a combination gas and electric company. It is also significant that the bill does not change the current law under which a company is automatically granted an exemption if it files for one in good faith and meets the specific geographic limitations set forth in the Act for exemption. Even in 1935, a company qualifying geographically did not have to bear the burden of proof in determining whether an exemption should be granted.

The second major provision of S.1174 that is of particular importance to presently exempt holding companies and independent operating companies that are considering the formation of holding companies is the provision in the bill that modifies the regulatory mechanism by which an exemption may be withheld, conditioned or revoked, modification of the "unless and except clause". At the present time, the Securities and Exchange Commission has extremely broad authority to condition or revoke retroactively a statutory exemption. As you know from the previous hearings, the consequences to a utility holding company of losing an exemption under the Act are very severe, indeed. As a result, many companies, including those that would presently qualify for an exemption under existing law, have been reluctant to do so for fear of their exemption being subsequently revoked, resulting in registration under the Act. This is especially true of combination electric and gas utilities that could conceivably be subject to a simplification proceeding under Section 11(b) of the Act pursuant to which such companies would risk the forced sale of either their electric or gas utility businesses. Similarly, many companies, including presently exempt holding companies, are simply unwilling to commit material assets to non-utility businesses if they risk the retroactive loss of their exemption or the forced divestiture of such assets. Thus, the use of a holding company structure which I believe serves the best interests of both investors and consumers is clearly being discouraged by the Holding Company Act, a 48 year-old statute that remains virtually unchanged since 1935.

Yet, as you know, the utility industry and, indeed, the Nation's overall economic structure, have changed dramatically since then. Similarly, regulation of public utilities at the state level has changed significantly since 1935 and has become more effective. Surely, it is time to reform the Holding Company Act so as to cause it not to discourage business activities and the use of a common corporate structure that are in the best interests of investors and consumers.

I respectfully submit that if a public utility is to fully and most economically utilize its assets and enter non-utility businesses, and I personally believe that such actions would provide economic benefits to public utility investors and consumers alike, such activities would best be accomplished by the use of a holding company structure with separate corporate subsidiaries for any utility and non-utility businesses. In my judgment, this structure would:

(1) facilitate effective state regulation of the utility business;

(2) minimize the possibility of any losses or liabilities to the utility and its ratepayers;

(3) prevent cross-subsidization; and

(4) facilitate the raising of capital on more reasonable terms, thus benefiting ratepayers.

Therefore, it seems to me, Mr. Chairman, of the utmost importance in any legislation reforming the Holding Company Act is the paramount need to assure state regulators of sufficient access to the books, records and accounts of any non-utility businesses to enable them to regulate effectively. I believe that S.1174 contains exactly such provisions in Section 5. This is an entirely new section, strengthening the provisions of the original Act, and guaranteeing state commissions a new, federally enforceable right to gain access to the books, records and accounts relating to non-utility activities of both exempt and registered companies. Section 5 provides that if a state commission, in the course of a proceeding, is not satisifed that it has been granted adequate access to the books, records and accounts of a holding company or a non-utility subsidiary thereof, it is granted a right of action in the United States federal district court to secure access to any records it can show to be necessary to the performance of its regulatory responsibilities. The bill also empowers the SEC to require bienniel reports on the non-utility activities of both exempt and registered systems. Moreover, state regulators are expressly provided the opportunity to apply to the SEC to require such reporting. Therefore, S.1174 significantly expands the ability of state regulators to gain information on non-utility businesses, thus facilitating their ability to regulate affiliate transactions and to prevent cross-subsidization, a point I will address next.

I would like to offer the following observations on the testimony you have just heard from the contractors. In my opinion, the best way to prevent cross-subsidization is through effective state regulation of the utility business. As I have mentioned, I believe S.1174 reforms the Holding Company Act in a manner that actually serves to enhance the ability of state regulators to regulate effectively. Moreover, the holding company structure provides for the clearest, most distinct separation of utility and non-utility assets, thereby facilitating regulation of affiliate transactions and minimizing the possibilities for cross-subsidization. Additionally, in the hearings last year, it was clearly established that proposals for repeal of the Holding Company Act were not a source of the contractors' problems, but rather that the

Residential Conservation Service and Commercial and Apartment Conservation Service programs were. There is, in fact, no federal prohibition against diversification by utilities that are not part of registered holding company systems, and even registered systems which are restricted to "functionally related" diversification can presently diversify into energy conservation areas. Indeed, it is interesting to note that both the electric utility industry and the contractors opposed passage of the RCS and CACS programs by the Congress in the late 1970s. And, finally, if on rare occasion there were isolated instances of anticompetitive behavior, such behavior would be properly addressed by our antitrust or other laws designed to prevent anti-competitive business practices. Thus, rather than increasing the threat of cross-subsidization, S.1174 provides mechanisms to better protect against it while leaving intact existing laws. Clearly, S.1174 is a constructive step in addressing the contractors' expressed concerns.

Another aspect of the bill that merits specific discussion in view of the concerns that were expressed last year by the American Public Power Association is the fact that state regulators have sufficient authority under existing law to regulate any potential utility combinations that may be inconsistent with the public interest.

For example, over half of the states require public service commission approval for the acquisition by a public utility of the securities or assets of another public utility. Virtually all of such states also regulate the sale of utility assets by requiring prior state public service commission approval of such sales. Other states prohibit such sales to companies that are not public utilities, while certain others also require state public service commission approval prior to the acquisition of a controlling interest in a public utility. I simply want to point out that these provisions, and, indeed, the original restrictions contained in the Holding Company Act on utility mergers or acquisitions, which S.1174 leaves unchanged, have been strengthened by the provision in the bill providing the SEC with effective power to prevent non-utility enterprises from superimposing themselves on a public utility.

Mr. Chairman, I would now like to spend a few moments talking specifically about Duke Power Company. We hope to enhance our Company's excellence by fully developing its demonstrated talents and expanding them, as appropriate, into non-regulated markets. These efforts will be service-oriented, not capital intensive, and they will utilize expertise and non-utility assets designed to provide synergistic benefits to our core electric utility business.

For example, Duke's wholly-owned subsidiary, Crescent Land and Timber Corp., owns approximately 270,000 acres of non-utility land. For years Crescent has conducted forestry and limited recreational land development activities. At the present time, it is involved in discussions with a major textile firm in our service territory concerning the possibility of utilizing wood chips as a new source of energy, possibly for the co-generation of electricity. Crescent has also engaged the services of a geological consulting firm to determine if its land contains other natural resources that could be profitably exploited. Crescent is also considering offering forestry management services to other landowners.

Mill Power Supply Company, another subsidiary, has been in the electrical equipment business for 73 years. It was originally established to market equipment to enable individual businesses to convert from water power to electric energy, and over the years Mill Power has expanded its business to include other forms of major electrical equipment. We believe that in the future Mill Power should be effectively positioned to market developing energy and conservation technologies. In this regard, Mill Power could provide synergistic benefits for Duke Power's load management program.

Another company in our ad hoc group, Pacific Lighting Corporation, whose Southern California Gas Company is the largest gas distributor in the United States, has also diversified into energy conservation areas as part of its long-term corporate strategies. For example, a subsidiary of Pacific Lighting is developing a scrubber system that cleans and upgrades the quality of "waste" biogas produced from sewage and landfills. Increased energy conservation and alternative energy sources are, of course, necessary elements in our Nation's energy future.

Finally, Duke Power's design engineering and construction team, some 8,000 strong, has developed a unique capability in our industry. It designs and constructs, in-house, all of Duke Power Company's power plants. These plants are the most efficient in the industry. As Duke Power's need for new construction declines, its design engineering and construction capability could be made available to others. For example, our design engineering and construction team has already undertaken as a pilot project the design of a nuclear waste disposal facility for another utility and is exploring other similar opportunities.

These are examples of the kinds of non-utility activities Duke Power plans to pursue in furtherance of its long-term corporate strategies. They are compatible with the core utility business, building upon it without requiring a large infusion of capital, a basic change in management style, or a unique kind of expertise. Moreover, we believe that the interests of both investors and consumers would be maximized if we were to utilize a holding company structure for such activities. While I cannot speak for other utilities, it is my belief that they would pursue a similar course in seeking opportunities for expansion of their non-utility business activities.

Mr. Chairman, I respectfully urge the Subcommittee to remove the unnecessary regulatory burdens that the Holding Company Act imposes on the electric and gas utility industry by supporting the quick passage of S.1174. This thoughtful and well-reasoned regulatory reform package is a far cry from repeal of the entire Act which our industry supported in the last Congress. We have compromised significantly in supporting this legislation, and, in the public interest, we urge others to do likewise.

I would like to thank you for the opportunity to testify today. This concludes my prepared remarks.

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June 30, 1983

The Honorable Alfonse M D'Amato
United States Senator
Washington, DC 20510

Dear Senator D'Amato:

Thank you for your letter of June 21, 1983 seeking responses to some additional questions related to your June 14 Subcommittee hearings on S.1174. I am pleased to furnish you with such responses as follows:

Question 1

S.1174 provides state commissions with a new, federally enforceable right to books and records of non-utility businesses and provides for expeditious consideration of any disagreements in the U S District Court. Shouldn't there be a specific time in which the District Court must act as Commissioner Schuler has testified? The state commission right to the books and records arises in the context of a "pending proceeding". Would you be opposed to modifying this requirement, possibly broadening it?

Answer

S.1174 provides that any action brought in U S District Court to produce books and records of non-utility businesses "shall to the greatest extent practicable be expedited by the court and given precedence with respect to other matters then pending on the docket so as to permit the court to render its decision relative to such action within 60 days from the date such action is brought..." (emphasis added). Duke Power Company would not be opposed to striking the requirement of a "pending proceeding" as one of the conditions precedent to a state commission obtaining the right to books and records of non-utility businesses.

Question 2

S.1174 provides that exemptions shall be granted upon application and withheld or revoked after there is "clear and convincing evidence" that maintenance of the exemption would "materially adversely affect" the system's public utility business. Shouldn't there be a standard for initially qualifying for an exemption? What criteria should be established for defining "materially adversely affects" and "clear and convincing evidence"? If the SEC is to promulgate such standards, will this require additional manpower?

Answer

Since 1935, there has been a statutory standard for initially qualifying for an exemption, to wit: Does a holding company system do business as a public utility within the geographically prescribed criteria for exemption set forth in section 3(a) of the Holding Company Act? If so, under Rule 2 that system would automatically be granted an exemption. In all the history of the act, there have been no problems with this procedure in granting exemptions. So please, if it ain't broke, don't fix it. On this point, S.1174 would simply change the geographic qualification.

In my judgement, no criteria should be established for defining "materially adversely affects" and "clear and convincing evidence". Rather, as is the case under the other federal securities laws, the SEC would make a determination as to what constitutes "materially adversely affects" on a case-by-case basis. This standard provides the administrative flexibility that is needed for the SEC to administer effectively the Holding Company Act, while at the same time reflecting the extraordinary remedy that the Holding Company Act grants the SEC when this standard has been reached. It is my belief that the SEC would require additional manpower to promulgate standards as they would continually have to be modified.

Question 3

In New York, the legislature mandated that specific Public Service Commission hearings be decided within eleven months. Many states have similar procedural time limits. Dr Schuler stated (on page 6) that "his staff is adamant in insisting the procedure proposed as Section 3A be shifted from the District Court to a more informal, administrative proceeding within the SEC" because "it is possible that by the time the disputed records are obtained through the Federal District Court the effective use of that information would have been mooted because of the state imposed time clock." Would you please comment on Dr Schuler's concern?

Answer

As I mentioned both in my testimony and in response to a question from Senator Sarbanes, I believe that it is most unlikely that Duke Power Company would ever force a jurisdictional state commission to resort to a federal court in order to gain access to the books and records of Duke Power Company's non-utility businesses. The concept of access to the U S District Court is intended as a "failsafe" mechanism if all other avenues of accomodation prove unavailable. It is unlikely to be often used.

Question 4

Dr Schuler suggests that the requirement that information requests under proposed Amendment 3A originate from an on-going proceeding has a Catch-22 quality. The reason being that all too frequently these information requests are used to form the basis for initiating a proceeding. Is this "theory" consistent with your experience?

Answer

As I mentioned in response to question 1, Duke Power Company would not be opposed to striking the requirement of a "pending proceeding" as a condition precedent to a state commission obtaining the right to books and records of non-utility businesses. Also, procedings of many sorts can be initiated on motion of a state commission without any pending application by a utility.

Question 5

In connection with utility diversification, you identify the antitrust laws as the instrument to address the concerns raised by the previous panel of contractors. Within your experience, have the antitrust laws ever been applied to any instance of utility diversification? Are the antitrust laws alone an adequate safeguard to protect consumers and competitors from exploitation? Would you object to allowing some role for the Justice Department's Antitrust Division in the consideration and approval of applications for utility diversification?

Answer

In my experience, there has never been a need for the antitrust laws to be applied in an instance of utility diversification. I believe that as in other industries, including certain regulated industries, the antitrust laws have been adequate to protect consumers and competitors from any unfair competition resulting from diversification by regulated companies. Moreover, as I indicated in my testimony, I believe the use of a holding company structure provides the best protection for both consumers and competitors. I would object to a formal role for the Justice Department Antitrust Division in considering approval of applications for diversification by public utilities. I believe that utilities should not be subject to additional antitrust regulation that is not equally applied to other industries.

Question 6

It has been said that utility ventures into traditional wholesale, retail and contracting functions are often subsidized by passing through part of the cost to their rate payers. Is this a fair assessment of utility practices?

Answer

I believe that it is an unfair assessment of utility practices to suggest that utility ventures into traditional wholesale, retail and contracting functions have often been subsidized by ratepayers. I believe there is no incentive for a state commission to permit such cross-subsidization. Indeed, there is every incentive for a state commission to prohibit such conduct.

Thanks again, Senator D'Amato, for the opportunity to testify before the Subcommittee and to provide my views on these written questions. I hope these responses assist you and your colleagues in the deliberation of S.1174 which I believe is in the best interests of investors, consumers, contractors and public utilities. If I can help in any other way, please let me know.

Very respectfully,

W S Lee

WSL/w

cc: Neil D Levin, Esq.

STATEMENT OF G. JACK TANKERSLEY, CHAIRMAN OF THE BOARD AND PRESIDENT, CONSOLIDATED NATURAL GAS CO., PITTSBURGH, PA.

Mr. TANKERSLEY. Mr. Chairman, my name is G. J. Tankersley and I am chairman and president of Consolidated Natural Gas Service Co. headquartered in Pittsburgh. I appear not only for my own company but for the Columbia Gas System also.

I have shortened my short remarks as much as possible.

[The complete statement and response to written questions of Senator D'Amato follow:]

WRITTEN STATEMENT OF G. J. TANKERSLEY
CHAIRMAN AND PRESIDENT
OF
CONSOLIDATED NATURAL GAS COMPANY

Mr. Chairman and members of the Subcommittee. My name is G. J. Tankersley. I am chairman and president of Consolidated Natural Gas Company, headquartered in Pittsburgh, Pennsylvania. I greatly appreciate the opportunity to discuss with you today the problems facing public utility holding companies registered under the Public Utility Holding Company Act of 1935, and the way in which S. 1174 would provide much-needed and long-overdue relief from some of those problems.

I appear not only on behalf of Consolidated, but also on behalf of the Columbia Gas System Inc., one of the only two other gas utility holding companies registered under the Act, and on behalf of eight of the nine electric utility holding companies registered under the Act. All of these companies are united in the conviction that prompt relief from the archaic and burdensome restrictions of the 1935 Act has become necessary, even urgent.

Today I would like to discuss particularly the restraints that the present Act places upon efforts of the registered companies to use their resources in the best and most efficient manner, and in a way most conducive to the public interest. While much of my discussion and examples will relate to the gas industry, since that is the one with which I am most familiar, the detriments suffered by the electric holding companies are also difficult and indefensible.

Under the present Act, these twelve registered holding companies may only acquire utility properties or properties, assets, or enterprises which are "functionally related" to their utility business. This has meant, in the case of Consolidated, that we could engage in the production of gas, and in connection with that own coal mines for the purpose of producing coal to be used in coal gasification programs, but without further authorization we cannot make any other disposition of the coal. It has meant we could not operate a commercial greenhouse using the waste heat and combustion products produced by our pipeline compressor operations.

These restrictions, though burdensome in the past, have become intolerable, unfair, and discriminatory in the times in which we live. The world of energy has undergone a revolution in the last decade, and the gas and electric industries have not been left untouched by it.

One dimension of that revolution has been conservation. Since 1973, conservation programs, which have been strongly encouraged by the gas and electric companies, have reduced the residential and commercial use of these energies by over twenty percent -- in other words, the average residential and commercial consumer in our marketing area has reduced his consumption of gas by over one-fifth in ten years. This trend, which is also seen in industrial use, is continuing and we fully expect declining markets in the future.

Moreover, the three registered gas companies have achieved an extremely high degree of "saturation" in their commercial and residential markets, with the result that there is precious little opportunity to expand our number of customers, and it is well recognized that the areas served by the three gas companies have a declining population base.

Further exacerbating our problems has been the industrial depression in our marketing area. Some have even referred to it as the "rust bowl." This area has been among the hardest hit in the country, with resulting catastrophic reductions in industrial and commercial gas consumption, and it is likely that these industries will never reach their previous levels of consumption.

Moreover, there is the probability of intensified competition from other fuels. Already in most places the cost of gas has surpassed that of No. 6 oil, and as the price of gas increases under the market pricing mechanisms of the Natural Gas Policy Act, the competitive pricing situation will worsen.

And finally, the product of the gas industry -- energy -- comes from a single exhaustible source -- gas. Although the present outlook for gas supplies is considerably brighter than it was five years ago, nonetheless we must recognize that gas is a finite energy source.

The electrical industry is afflicted by many of these same problems: reduced loads because of conservation; industrial declines; competition from other fuels.

Further aggravating our problem is the grossly unequal way the law treats registered companies compared to other companies. Over eighty percent of the gas supplied in this country is distributed by utilities which are either parts of exempt holding company systems or companies which are not in holding company systems. All of these companies, subject for the most part only to state restrictions, are free to pursue diversification activities virtually without limit. The results of this inequity are dramatic.

For instance, some years back, a subsidiary of a then-registered holding company was denied the opportunity to invest in an inner-city low-income housing project in its utility service area in Detroit because the investment was deemed not to be "functionally related." Contrast this denial with the remarkably successful work the Brooklyn Union Gas Company -- which is not subject to the Act -- has done with its "Cinderella" project, which upgrades housing in Brooklyn. Why could a utility be involved in upgrading housing in Brooklyn but not in Detroit? The answer is simple: one was not subject to the archaic restrictions of the 1935 Act; the other was.

Another striking example of these unfortunate effects of the 1935 Act developed after the enactment of the Public Utility Regulatory Policies Act of 1978. That legislation sought to mitigate the nation's energy crisis, in part by encouraging both utility and nonutility enterprises to engage in an efficient form of energy production called "cogeneration," which involves the production of electricity as well as other forms of useful energy, such as steam. Implementing rules by the Federal Energy Regulatory Commission had the salutary effect of enabling all American enterprises to participate in cogeneration -- all, that is, except for the three registered gas holding companies. Exempt public utility holding companies, utility companies, registered electric public utility holding companies -- in fact, every business in the United States save the three registered gas utility holding companies -- are statutorily authorized to engage in such projects. Why this astonishing denial of opportunity to these three companies alone? The obsolete and archaic restraints of the 1935 Act.

Even when we do attempt to expand into "functionally related" businesses the Act handicaps us. Unlike other businesses, before we can consummate a proposed acquisition, a minimum of twenty-five days' notice must be given. And, of course, the Commission has the authority, under extremely broad powers, to disapprove the transaction. Would-be sellers are reluctant to enter into transactions beset with such delays and uncertainties, with the result that acquisition opportunities of registered companies, even when allowed, are severely hampered.

The Act also discourages our use of research to seek out new areas of endeavor internally. For instance, we spend large amounts to develop gas-related opportunities. If in the course of those efforts we develop a process or product that is not functionally related, we cannot exploit that development. Thus, even if we successfully develop new heat treating equipment to enhance the use of gas, we cannot then market that product no matter how promising it might be.

S. 1174 would redress such situations by eliminating both the functional relationship test and the requirement for prior SEC approval of each nonutility investment decision, substituting instead a more flexible, realistic, and fair method of regulating diversification.

First, the proposed amendments would permit registered systems to make nonutility investments without SEC approval within a "safe harbor" of up to ten percent of the system's consolidated assets. This "safe harbor" is provided since such modest diversification is unlikely to bring about any of the dangers that some purport to see in diversification by the twelve registered holding companies. Yet it is still far short of the freedom which exempt companies now enjoy.

When the ten percent threshold is reached, no further acquisition could occur except through specific SEC approval of the acquisition or of a diversification plan with which the acquisition was consistent. The SEC may disapprove a specific acquisition or a diversification plan if it finds that the acquisition or activities described in the plan are likely to result in an unnecessary and unreasonable increase in costs to consumers or impair the performance of utility service in a manner inconsistent with service obligations under applicable state law. The amendment would require that state authorities be given contemporaneous notice of any application for approval of a specific investment or of a diversification plan, and if they believed it should not be approved, they would have a right to be heard.

The amendments also grant the SEC authority to require divestiture of a nonutility investment if the retention of that interest materially adversely affects the public utility business of the holding company system. A state could participate in an SEC divestiture proceeding as an interested person.

As an additional safeguard against any impairment of public service obligations arising from diversified activities, S. 1174 would continue the authority of the SEC to protect the integrity of utility company assets and financial commitments by regulating intercompany transactions. This authority would include

-- authority to restrict extensions of credit by a public utility company to another company in the same holding company system; and

-- authority to establish requirements governing any other transaction between a utility company and any affiliate or any other company in the same system.

The SEC would also be empowered to restrict sales of utility securities and assets by the holding company.

Further protecting the public utility investments of a holding company from any possible harm from diversification activities is the ability of the state commissions to allocate costs between jurisdictional and nonjurisdictional services in the context of the rate case. S. 1174 provides a federally enforceable right to the state commissions to gain access to relevant books, records, and accounts with respect to nonutility activities of both exempt and registered holding companies. This strengthens considerably the ability of the state commissions to allocate costs between the provision of utility services on the one hand and diversified activities on the other.

Before closing, I would like to assure you that it is not our intent, and I am confident the same is true of the other registered companies, if S. 1174 is enacted, to undertake an acquisition spree that would take us far afield from what we know best -- energy. All of the thinking we have done about these matters has concentrated on activity that would take us into areas where we have knowledge, expertise, skill, and experience.

In summary, in new business activities and in existing ones, the registered holding companies cannot compete on an equal footing with other enterprises. We cannot move as fast. And we cannot move as far. And we do not have access to all of the means available to other utilities to protect our stockholders' investment and to best serve our customers. Clearly, a change in the Public Utility Holding Company Act is in order. We know our markets are changing. We know the country's energy situation is changing. Capital markets are changing. And technology is changing. Mr. Chairman and members of the Subcommittee, we need a fair opportunity to change too.

Thank you.

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G. J. TANKERSLEY
Chairman and President

July 20, 1983

The Honorable Alfonse M. D'Amato
United States Senator
Washington, DC 20510

Dear Senator D'Amato:

I am pleased to respond to the questions contained in your June 21, 1983 letter concerning S.1174. Your continuing and detailed interest in this matter is much appreciated. Before responding to your specific inquiries, it may be helpful to set forth generally how Columbia Gas System and Consolidated Natural Gas Company perceive the existing authority of state commissions since that is a main concern of your questions.

It bears repeating that each utility is entirely dependent on its state commission and law for the rates it is able to charge its customers and, therefore, the utility return it is allowed to earn for its investors. Equally clear is the fact that if a utility is unwilling to supply data or information relevant to a commission decision on, for example, the appropriate allocation of costs between a utility and a non-utility function, the commission can — and invariably will — simply disallow the questioned amount in the utility's rates. Given this absolute dependency, it is difficult to imagine that a utility or an affiliate would rebuff a request, even if only marginally reasonable, for relevant information concerning its affiliates. Any further extensions of the power of state commissions should come from the state legislatures which created them rather than Congress. For instance, Commissioner Schuler's Catch-22 claim could easily be cured by the New York legislature. S.1174 enhances the power of state commissions and is not the source of any dilemma to them.

Question No. 1

S.1174 provides state commissions with a new, federally enforceable right to books and records of non-utility businesses and provides for expeditious consideration of any disagreements in the U. S. District Court. Shouldn't there be a specific time in which the District Court must act as Commissioner Schuler has testified? The state commission right to the books and records arises in the context of a "pending proceeding." Would you be opposed to modifying this requirement, possibly broadening it?

Answer

There is no need to legislate a more specific time within which U. S. District Courts should be obliged to render their decisions than is already proposed by S.1174. This new proposed right of access to the books and records of a utility's non-utility affiliates overlays and extends existing rights the state commissions have to secure information. Except under extreme circumstances, S.1174 effectively mandates a decision within 60 days from the date the action is filed. If 60 days is too long, then the state commission could petition for and receive accelerated consideration of their action upon a proper showing of the need for such relief. I submit that utilities have a great interest in securing speedy state commission action especially in rate cases and that state laws imposing decisional time limits were not directed at delays caused by utilities. Certainly, the state legislatures have the power to solve any problems which might arise in this area. There is no need for S.1174 to anticipate all imaginable "what if" situations.

The second point you raise is whether the state's rights of access to books and records of a non-utility is adequate if the right only arises in a pending proceeding. Since state commissions generally have the right to initiate proceedings with respect to its regulated subjects, it is difficult to visualize when a commission could not institute a proceeding and yet still have a valid interest in exercising its right of access to a non-utility affiliate. I am not aware of any precedent for any similar delegation of such unbridled authority. It would surely tempt some commissions to engage in fishing expeditions through affiliate records and spawn more litigation. We should keep in mind that this new right for state commissions is also a new burden on the non-utility affiliates whose competitors are not likely to overlook the information which becomes available through such reviews especially as it may pertain to costs, capital expenditures and financing plans. It is perfectly proper and reasonable to tie this new right to appropriate standards as S.1174 provides. Accordingly, we would be opposed to loosening this requirement.

Question No. 2

S.1174 provides that exemptions shall be granted upon application and withheld or revoked after there is "clear and convincing evidence" that maintenance of the exemption would "materially adversely affect" the system's public utility business. Shouldn't there be a standard for initially qualifying for an exemption? What criteria should be established for defining "materially adversely affects" and "clear and convincing evidence?" If the SEC is to promulgate such standards, will this require additional manpower?

Answer

The present 1935 Act has objective standards for initially qualifying for an exemption. S.1174 continues this objectivity in Section 3(a) which sets forth six very precise situations under which a holding company is qualified for exemption. There is little likelihood of a factual dispute over whether a holding company qualifies for exemption. If a holding company fits within one of these six specific categories, it should be exempted unless it is clearly proven that exemption would have a materially adverse effect on the public utilities within the holding company system. Any lesser standard for withholding or revoking an exemption could lead to inappropriate encroachments on management's duty to efficiently deploy the company's assets and the potential abuse of such exemption proceedings by third parties seeking to impose their ideology on the private utility industry.

The standards in the bill for withholding or revoking an exemption have long been used in the accounting and legal professions and exemptions have been subjected to much judicial clarification. In the remote likelihood that one of the 12 remaining active holding companies were to present a close case for exemption, the SEC could readily look to those cases for clarification. It would seem unnecessary to promulgate regulations defining such terms under these circumstances.

Question No. 3

In New York, the legislature mandated that specific Public Service Commission hearings be decided within eleven months. Many states have similar procedural time limits. Dr. Schuler stated (on page 6) that "his staff is adamant in insisting the procedure proposed as Section 3A be shifted from the District Court to a more informal, administrative proceeding with the SEC" because "it is possible that by the time the disputed records are obtained through the Federal District Court the effective use of that information would have been mooted because of the state imposed time clock." Would you please comment on Dr. Schuler's concern?

Answer

One answer is, as indicated in my preamble, that in the real world the utility is already under great pressure to provide the requested information. Secondly, unless Dr. Schuler's staff intends to prohibit the right of a non-utility affiliate to appeal from an adverse ruling, it would seem that adding an informal administrative proceeding would merely add to the time it would take to secure a final decision on the merits of a record inspection request. Besides that, the wisdom of establishing the SEC as the adjudicator between a state commission and a utility involved in a proceeding must be seriously questioned. The SEC's staff and costs would likely increase in order for it to establish its own adjudication process, rules, personnel and facilities to resolve such questions. One must conclude that the position of state commissions under this statute would be improved if right of access disputes could first be brought into federal district courts. The courts have the power to enforce their orders, have well-defined procedural and evidentary rules and can give accelerated consideration when appropriate.

Question No. 4

Dr. Schuler suggests that the requirement that information requests under proposed Amendment 3A originate from an ongoing proceeding has a Catch-22 quality. The reason being that all too frequently these information requests are used to form the basis for initiating a proceeding. Is this "theory" consistent with your experience?

Answer

We have no experience with the "theory" but suggest that state legislatures are perfectly capable of solving any real problems. Since Section 3A connects the exercise of this new right to a commission's legally imposed functions, it would presumably have the right to initiate an appropriate proceeding. There is no Catch-22 quality to requiring public service commissions to first demonstrate that there is a relationship between the utility and its affiliate which is germane to a lawful and legitimate pending proceeding in order to justify access to an affiliate's records. Rather, it would be shocking if state commissions were authorized to search the records of non-utility affiliates in order to find some basis for initiating a proceeding. Bluntly, this right to issue "information requests" would be a federally authorized subpoena power. The recipients of such subpoenas ought to have some protection against their abuse.

Question No. 5

In connection with utility diversification, you identify the antitrust laws as the instrument to address the concerns raised by the previous panel of contractors. Within your experience, have the antitrust laws ever been applied to any instance of utility diversification?

Are the antitrust laws alone an adequate safeguard to protect consumers and competitors from exploitation?

Would you object to allowing some role for the Justice Department's Antitrust Division in the consideration and approval of applications for utility diversification?

Answer

I am not aware of any instance where the antitrust laws have been applied to the diversification attempts of a gas or electric utility or holding company. However, your question certainly would encompass the historic rearrangement of AT&T. There has never been any doubt that the antitrust laws apply to utility diversification just as they apply to diversification by companies in other businesses. I will add, so there is no misunderstanding, I am equally sure the antitrust laws apply to all utility activities and not just its diversification efforts, with but limited exceptions like the Noerr-Pennington doctrine, the exclusive jurisdiction doctrine and the state action exemption.

Consumers and competitors of utilities need not look to the antitrust laws alone for protection from exploitation. The Federal Trade Commission as well as state consumer protection agencies and state public utility commissions are charged with the protection of consumers and competition, and these commissions have sufficient power to perform this function adequately.

The Justice Department's Antitrust Division already has a significant role in the consideration and approval of applications for utility diversification. Under the Hart-Scott-Rodino Act, utilities must file premerger notification with the Antitrust Division (and the FTC as well) prior to a significant acquisition. As you know, before such an acquisition can be consummated, there is a thirty-day waiting period during which the Antitrust Division reviews the competitive consequences of the proposed acquisition. The Antitrust Division can seek to enjoin an acquisition it believes will have anticompetitive effects. A special role for the Justice Department would exacerbate the already extensive regulatory maze which governs utility holding company diversification activities.

Question No. 6

It has been said that utility ventures into traditional wholesale, retail and contracting functions are often subsidized by passing through part of the cost to their rate payers. Is this a fair assessment of utility practices?

Answer

This is not a fair assessment of utility practices. No state commission would countenance utility cross-subsidization of any non-utility functions. Such a practice would violate state utility laws. Furthermore, the opportunities for such cross-subsidization are few, and the chances to escape detection are remote. Utility costs become essentially public records reviewed for reasonableness and legality by state commissions, consumers and competitors. Moreover, we are convinced that it is in the best interest of utilities to promote the goodwill of the independent businesses which furnish the bulk of such services.

Thank you for this opportunity to elaborate on the concerns your questions have raised. I trust this helps complete the hearing record on S.1174 and that progress towards its enactment will continue.

Sincerely,

G J Tankersley

G. J. Tankersley
Chairman of the Board and President
Consolidated Natural Gas Company

cc: Neil D. Levin, Esq.

Senator D'Amato. Thank you, Mr. Tankersley. Mr. Nichols.

Mr. Nichols. Thank you, Senator, and I would like to comment very briefly on the financing sections of S. 1174. This is an area that is perhaps the least controversial of the three areas that we are addressing, and I think it is least controversial because I think there's widespread recognition that the financing controls of the 1935 act are discriminatory against the registered public utility holding companies and to continue them unaltered would be expensive and unnecessary for the customers of the utility companies in those holding company systems.

THE 1935 ACT IS DISCRIMINATORY

The 1935 act is discriminatory because it imposes an extra level of regulation on these 12 companies that does not exist for most utility companies. As companies whose stock is publicly held, we not only have to meet the requirements of the Securities Act of 1933 and the requirements of the Securities Exchange Act of 1934 and many of us also have to meet the requirements of State utility commissions for the issuance of our utility companies securities.

The 1935 act imposes on registered companies yet another layer of financial supervision. This extra level is, we believe, discriminatory and not needed today. It is not needed today but was needed back in 1935 for a very simple reason. Back in 1935, the Securities Act of 1933 and the Securities Exchange Act of 1934 had not yet had a chance to be implemented and most of the securities—in fact, practically all of the securities of the then holding companies had been issued prior to those acts; and, in addition, under section 11 of the 1935 act—the breaking up of the massive pyramidal structures, had not yet taken place.

That breaking up has now taken place. The overlapping layers of control have been removed and the 1933 act and the 1934 act have had a chance to be implemented.

In addition, nearly all of the regulated utility companies are today subject to standards governing both financing and capital structure imposed by their State commissions.

The additional level of securities resolution does not help us gain access to any capital markets. Rather, it tends, due to the time requirements, to make it more difficult to access capital markets in a quick and easy and least expensive fashion.

There's one area that was referred to earlier this morning that is particularly troublesome during times of market volatility, and that is the generally imposed requirement that we sell our securities through competitive bidding. We can get exemptions but those are not always granted. In fact, on the average, they have been quite hard to come by. During periods of market volatility this requirement makes financing more expensive for our customers.

We think these additional constraints should be discarded because they are redundant and they are detrimental to our customers as well as to our investors.

At the same time, we do recognize that some State regulators believe the SEC should have the authority to prevent practices that might be harmful, S. 1174 is designed to give the SEC this authority. As amended, the Act would retain in the SEC the authority to bar the issuance of securities by the holding company that it believes might be harmful. However, the commission could not bar these practices that are commonly and beneficially used by other utility companies.

Under S. 1174, the SEC would retain authority to review all the securities issuance of the public utility holding companies that are not authorized by State commissions. They would also have the authority to review the issuance of all securities by the holding company except for limited amounts of short-term debts and limited guarantees and assumptions of liability by the holding company.

We believe S. 1174 in its financing section does go a long way toward a solution of these problems. We recommend the changes to you, sir.

I would like to say on behalf of our panel that we are pleased with your continued interest and we think we can move forward and develop legislation that will be helpful to the investors and the customers of the public utility holding companies. Thank you.

Senator D'AMATO. Thank you very much. Let me thank the panel and I just have several quick questions.

The American Supply Association states that the Public Utility Holding Company Act should remain intact because "among other things, when competing head-to-head with small business, utilities enjoy a massive marketing advantage through their penetration into every home, office building and factory."

How do you respond to those concerns about unfair competition, and the concerns we've heard today?

PASSING COSTS TO THE RATE PAYERS

Also it's been said that utilities' ventures into traditional wholesale, retail and contracting functions are often subsidized by passing through part of the cost to the ratepayers. Is this a fair assessment of the utility practices and what, if anything, can be done to deal with these concerns?

Mr. LEE. Could I respond, Mr. Chairman?

Senator D'AMATO. Certainly.

Mr. LEE. For the group I represent, the Public Utility Holding Company Act doesn't affect an answer to that question at all. That is a matter of State regulatory commission, the Wright-Patterson Act, the Federal Trade Commission, anticompetitive, antitrust provisions in the law. But what this bill does do would be to give companies like Duke Power an opportunity to more clearly differentiate, to remove the spectre or the reality of cross-subsidization if it exists, and give the competitors an opportunity for recourse because it will more clearly separate books and enterprises than we are now permitted to do under law.

So I submit that S. 1174 under the present Holding Company Act does not affect those two concerns. S. 1174 does in fact aid the relief of those concerns.

Senator D'AMATO. Would you be opposed to any language or amendments to S. 1174 that would specifically deal with the areas of concern that you have heard testified to by the small business community?

Mr. LEE. Yes, Senator, I would, for this reason: The core matter of the Public Utility Holding Company Act is legislation for the protection of the public utility customers and investors. That's the core matter.

With respect to anticompetitive activities, there are many other laws on the books that speak to that and other agencies other than the SEC.

Senator D'AMATO. Let me give you a practical consideration. I don't think that we should tie it necessarily to the SEC. This Senator might be willing, if there is sufficient support, to offer a floor amendment to S. 1174 to get around some other jurisdictional problems that we might face.

So I just throw that out for you to think about so we don't get bogged down in this legalistic argument as to who should and shouldn't have jurisdiction.

Mr. NICHOLS. If I may comment, I agree in principle with everything that Mr. Lee said. At the same time, we've made the progress we've made by working with all the parties that are interested and we will certainly use our best efforts to accommodate this particular interest.

Senator D'AMATO. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Gentlemen, I want to ask a couple of somewhat broader questions, just to get some sense of what it is you see as the goal or objective here.

LIMIT OF PUBLIC UTILITIES ACTIVITY

Leaving aside for the moment the different operating environment in which the registered systems and the nonregistered systems now find themselves—and I recognize that's an important point—what is your view on the nature of the activities in which you think a public utility should be able to engage? In other words, is it your view there should be no limit, or that there ought to be some limits, or that in practice there will be limits and therefore there's no need to have legislative limits?

I was struck by the fact that the examples repeatedly cited, Mr. Lee, by you and by others, were all under the energy umbrella; but is it your view that you should be able to participate in whatever activity you choose, if you get this diversification?

Mr. LEE. Senator, my view would be that with the separation that would be possible under S. 1174 the diversified activities would really be in any area as determined by market forces and the subsidiary would be free to fail or to succeed without impacting the utility ratepayers, and that to me is crucial.

Now from a matter of business judgment and through some sad experience, I have learned that those businesses in which we are diversified ought to be businesses to which we can bring something to the matter in the way of expertise which is largely the energy business. We have had sad experience in a diversified business where we knew nothing about it, but we thought it was a good idea, and we fell on our face and we were free to fail?

Senator SARBANES. And did that affect your ratepayers?

Mr. LEE. No, sir; it did not.

Senator SARBANES. Had you succeeded, would that have affected your ratepayers?

Mr. LEE. No, sir. We think not, if all the accounting was done just right. It might have if we had succeeded—it was a small business, a total of $5 million was involved and we're a $7 billion company, so it wouldn't have made a great deal of difference.

Senator SARBANES. Suppose the amount involved had been a lot larger in comparison to the size of the company. Would that have made a difference?

Mr. LEE. If we had failed in the business, it would have perhaps created a perception that our common stock was not worth as much, but if we had succeeded it might have created the perception that our common stock was worth more, in which case the cost of our total capital might have been different.

Senator SARBANES. To the extent that's the case, either way, it can't simply be asserted that the diversification has no potential impact on the company and how it's perceived and therefore would have some potential impact on the strictly utility side of its activities. Wouldn't that be correct?

Mr. LEE. Yes, that is correct, Senator. That is one of the reasons why, in my business judgment, we would only be in those businesses where we had something to bring to the party, some expertise that was needed in that area. Therefore, in my view, our chances for success would be high. In my view, under our free enterprise system, that would give us an opportunity to have the value of our companies perceived as being stronger and higher and that would benefit the electric utility people.

Senator SARBANES. I think that's a pretty good response, but it then leads to this question. What would be wrong—assuming again it could be done, and I don't minimize that task—with defining the areas of potential diversification to conform to what you just indicated, in terms of your knowledge and expertise and likelihood of success, or at least to preclude far-flung activities that do not carry any of that element with them?

Mr. LEE. Senator, I would urge you not to be so prescriptive. For example, it may come as a surprise to you that one of our diversified activities is the timber business. It's a far reach from energy.

Senator SARBANES. I read that example.

Mr. LEE. We've been in that business since 1939 and are very successful in it.

Senator SARBANES. I understand that. I read that example and I was interested in it because as it was put you certainly gave it an energy focus. If I may just quote that very example is in part what led me down this line of questioning. It was on page 11.

Mr. LEE. You're correct. Our timber business may have some energy impact, but it is peripheral to the reasons we went into that business in 1939 and the energy aspects of it are only very recent and very new.

Senator SARBANES. Does anyone else have a comment?

Mr. TANKERSLEY. I'd just like to make one point that I think is germane to your statement and that is, statistically, those gas companies and natural gas pipeline companies that are diversified now into many different things, obviously not subject to the act, are selling at higher multiples than those of us who are subject to the act. Their stock is selling above book which, of course, makes them stronger companies. They can sell equity more easily without dilution and in general in the financial markets they are looked upon as stronger investments than those of us who are restricted to the direct distribution of natural gas.

Senator **SARBANES**. That's a good point. I tried to set it to one side right at the beginning, but I recognize that the different treatment of companies within the utility business creates the kind of situation we're talking about.

What I was trying to get at, though, is where is it you gentlemen want to go? Do you want a situation in which a utility company can run a department store as a wholly-owned subsidiary, just to take that as an example?

Mr. **NICHOLS**. If I may answer that just as one utility executive, the answer is I don't want to go into the department store business and would vote against it.

Senator **SARBANES**. What would assure that that wouldn't happen? Why wouldn't you want to go into it?

Mr. **NICHOLS**. Because I don't think we, as a company, would bring any particular expertise or knowledge to that business. Along with Mr. Lee, before we have diversified into any area we have made sure first that we had some knowledge, some benefit to bring to that business that would be helpful to our future success.

Senator **SARBANES**. But you see, you're operating one subsidiary in the holding company situation that cannot be allowed to fail under any competitive circumstances, and that's your utility activity.

Mr. **NICHOLS**. Failure is a degree.

Senator **SARBANES**. Do you agree with that?

Mr. **NICHOLS**. No. I've been in the unfortunate position of having a utility with a negative return on common equity for a significant period of time. But while that may not have been a failure in terms of going into bankruptcy, it was certainly failure from the viewpoint of the typical investor.

If I may, I'd like to make three points in this area. One is that diversification is taking place across this country by a very large number of utilities and there are only 12 utilities that are subject to this particular act. The reason that more companies don't adopt a public utility holding company structure was well pointed out by Mr. Lee. There are real problems in operating under this structure and costs, and this structure discriminates against our investors and customers. We want to avoid that. But the utility holding company structure should be encouraged to permit the easiest, most accurate accounting for diversified activities to protect the customers of the utility companies. It will be much easier for the State utility commissions to regulate the utility companies if the diversified companies are set up in separate corporations under the holding company umbrella.

Finally, I would just like to mention that we are in some other businesses such as the oil and gas business. We went into that 10 years ago and for most of those 10 years it has been a good business for us and it has helped us secure a supply of fuel for our customers. There were times during that 10 years when we were very appreciative of that help.

Senator **Sarbanes**. Last year, on that very point, we heard testimony that a FERC study on utility-owned coal mines revealed that utilities paid significantly more for their own coal as compared to coal purchased from noncaptive sources. First of all, do you differ with that study and facts; and, second, if not, what is your argument that you would advance as to why that is not as undesirable a situation as it may appear on first reading?

Mr. **Nichols**. I would like to comment on that last point if I may. I expect there has been some additional security of supply for some of those companies that was of great value that was not reflected in the price, and I think that is a factor that utilities always must take into consideration.

Just speaking as one utility—It's one thing we have never gone into—the coal business—and have no current intentions to do so. We've looked at it a number of times. But I don't think there can be any guarantee that any diversified effort is going to succeed, which is one of the important reasons to encourage the holding company structure to permit the isolation of that activity. I think that is very important.

I perhaps should also mention that some of us who are registered companies have diversified to a limited degree and we have done so under the existing act. It's not easy to do so but we have done so, and frankly we have done so because we have had a great deal of cooperation from the SEC staff that administers the act, and in no way are we encouraging the passage of S. 1174 because of failure to regulate reasonably or well.

PASSAGE OF S. 1174 WILL ELIMINATE DISCRIMINATION

We are encouraging the passage because it will eliminate the discrimination that exists under the act and it will make more certain that we will have equal access to the financial markets, for example, with other utilities, and really that's all we're asking.

Senator **Sarbanes**. I understand that point with respect to a regulated company. I'm not quite clear, Mr. Lee, why you all don't want to just go on as you are. What is it that forming a holding company would enable you to do?

Mr. **Lee**. We think it would enable us to more clearly separate our utility functions from our diversified functions.

Senator **Sarbanes**. That was said earlier. You would be doing the public service commission a favor because they could see it more clearly, but is there no other benefit that's going to flow to the company from going to a holding company arrangement?

Mr. **Lee**. It would give us an opportunity to finance diversified activities through nonutility sources and not only using our retained earnings, without them looking through to the parent utility.

Senator **Sarbanes**. Do you think that the State regulators should have to go to Federal court to look at the books of a holding company for its nonutility activities if in fact we're going to move in the direction that you all are seeking?

Mr. **Lee**. Before you entered the room, Senator, I did comment on that.

Senator **Sarbanes**. I understood your comment to be that you never thought you would force them to go into court because that would exacerbate your relationship with them in the utility area. That's not the question. The question is why they shouldn't have that access without having to resort to court. Would you agree that they should?

Mr. **Lee**. I think as a matter of practical fact they have that access, but their recourse in the bill is to go to Federal court and I think the safeguard ought to be there.

Mr. **Nichols**. If I may comment, this is one of the safeguards that were built into S. 1174 to meet the requests of the State utility commissions.

Senator D'**Amato**. Senator Sarbanes. The present act doesn't give the PSC's of the local States the ability to do so and as a result of meetings with various regulatory agencies it was suggested that this would be a format that they could support. So I think it's an enhancement and it came about as a result of this bargaining during the past year.

Senator **Sarbanes**. I understand that, Mr. Chairman, but perhaps there should be some more bargaining. There's an effort here to put a package together and I don't differ with that effort, but I do think that we need to understand what it is we're trying to move to. I want to get very much to where it is you want to end up so I can work back from that.

Let me ask you gentlemen this question. One of the basic purposes of the 1935 act was to restore utility operations to local control and management. That was the generally perceived purpose at the time.

IMPACT OF PROPOSED LEGISLATION ON LOCAL MANAGEMENT

In your view, how would the proposed legislation affect this matter of local control and management of utility operations?

Mr. **Lee**. In my view, it wouldn't change it.

Senator **Sarbanes**. What do you think, Mr. Jackson?

Mr. **Jackson**. Sir, we are not under the act and it would perhaps be inappropriate for me to attempt to comment in this area.

Senator **Sarbanes**. Your concern, as I understand it, is the possibility of take-overs of utility companies by nonutility companies.

Mr. **Jackson**. Yes, sir.

Mr. **Nichols**. Senator, may I respond to that question? Section 11 of the 1935 act was the so-called divestiture section and under that section the massive complex utility structures that were notorious back in the 1920's were broken up and control was restored down to the local, State, and regional level. That was accomplished. And S. 1174 does not withdraw any of the provisions in the 1935 act which require the SEC to inquire into the acquisitions of any other utility companies. Indeed S. 1174 adds to them additional controls on acquisitions.

So I think the answer to your question is that issue was addressed under the 1935 act. The proper results were accomplished, and the provisions that pertain to that area of the 1935 act are not changed and are strengthened.

Senator **Sarbanes**. Do you see any problems in the reach of the State public service commission? Do they continue to address their responsibilities with respect to interstate utility holding companies? Would you have a situation in which the commissions in effect did not reach or have a sufficiently comprehensive jurisdiction to address matters that they might appropriately address?

Mr. **Nichols**. Having come through a decade of rather difficult period of time for all utilities, I would have to say that lack of jurisdiction and lack of regulation hasn't been one of our problems. And I would say this, however; that S. 1174 actually gives the States certain authorities that they now do not have, both in the area of financing as regards their ability to come before the SEC, and the earlier matter that Senator D'Amato referred to as regards their ability to gain access to information. So it actually enhances the State authority.

Mr. **Tankersley**. In the last round of testimony Luther Heckman, who was chairman of the Public Utilities Commission of Ohio at one time, and also Richard Dunham, who was Chairman of the Federal Power Commission, both testified in favor of the bills that were then being considered. Then Mr. Heckman, as I remember, said that in his 4 years as a commissioner not at any time did he find that the Holding Company Act affected his way of regulating utilities. He had all the tools he needed to regulate the utilities in Ohio, regardless of the act and any changes in the act.

Mr. **Lee**. Senator, could I please comment on an earlier question with respect to any thought about prescribing the type of diversified businesses. I think that would be very dangerous. It is not now so prescribed to those of us that are not under the Holding Company Act. If it were prescribed as a part of the Holding Company Act, then that may turn out to be onerous to the extent that we would continue to opt not to come under the Holding Company Act and therefore we would fail to receive the benefits to consumers, investors and I say the contractors and other competition that S. 1174 would provide by giving us a cleaner organizational structure.

Senator **Sarbanes**. Do your State regulators now prescribe you in any way?

Mr. **Lee**. Yes. One State, before we set up another subsidiary, requires their approval.

Senator **Sarbanes**. In terms of the activities which it goes into?

Mr. **Lee**. No. They just say that before you set up a subsidiary, come to us and ask us about it.

Senator **Sarbanes**. Mr. Chairman, I see my time is up. I think this has been a very helpful panel and obviously the witnesses have addressed these matters very carefully.

Senator **D'Amato**. Senator Sarbanes, do you have any additional questions, because we're going to stand in recess until tomorrow at 9 a.m.

Gentlemen, let me thank you very much not only for coming in and testifying but also for your work; on this matter. We've still got to deal with the problem of cross subsidization because it is an ongoing concern within the small business community.

Mr. Lee, you have dealt with it well in your practice. However, there are others who may not have been so conscientious. Therefore small contractors rightfully remain concerned. I'm just suggesting that we're going to have to deal with this problem if we're going to be successful. Senator Sarbanes also conveyed some of his concerns. I think that the bill moves in the right direction by giving PSC's access to books and records. They haven't been able to get them and I have experienced the same resulting frustration as a local administrator. When we had problems with the utilities I requested their books and records but our own public service commission couldn't give us that information: We felt that some of their other activities were draining off valuable resources, yet we couldn't support our beliefs. So I think we have begun to move in the right direction. I thank you for your participation and we stand adjourned until tomorrow morning at 9 o'clock.

[Whereupon, at 12:55 p.m., the hearing was recessed, to be reconvened at 9 a.m., Wednesday, June 15, 1983.]

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983

WEDNESDAY, JUNE 15, 1983

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9 a.m., in room 538, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Sarbanes.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The committee will come to order. This morning the subcommittee will continue its review of S. 1174, amendments to the Public Utility Holding Company Act.

Senator Johnston was to be here today but due to schedule commitments he is unable to appear. Therefore he has requested that his prepared statement be inserted as though read.

STATEMENT OF J. BENNETT JOHNSTON, U.S. SENATOR FROM THE STATE OF LOUISIANA

Senator JOHNSTON. Mr. Chairman, I am pleased to appear here today in support of S. 1174. This bill provides important and necessary changes in the Public Utility Holding Company Act of 1935. I very much appreciate the opportunity to join you as a cosponsor of the bill and to urge the subcommittee to take favorable action on this long overdue regulatory reform legislation.

The Holding Company Act in its present form constitutes one of the most complicated and extensive set of regulatory controls on corporate activity ever imposed under Federal law. While in 1935 this law may have been necessary to insure the simplification of electric and gas utility holding companies, the act has outlived its usefulness. In the first 20 years of the act's history, the Securities and Exchange Commission accomplished the necessary financial restructuring of the electric and gas utility industries. Today, the act's central purpose has been well and fully implemented. Nevertheless, the act remains in place, continuing to impose archaic regulatory limits on the corporate activities of utilities.

Last year, the SEC reexamined its historic role in the corporate regulation of electric and gas utility companies. It concluded that the Holding Company Act has no continuing valid regulatory purpose. I strongly agree with the SEC's view. And last year, I introduced legislation that would have repealed the act.

I believe that the hearings held before this subcommittee last year well demonstrate that the SEC correctly concluded that the act imposes unreasonable and unnecessary constraints on the business judgment of utility managers. I urge this committee to look carefully at the record developed last year, which also provides ample proof that the act's regulatory purposes are now better served by other State and Federal regulatory authorities.

Since the enactment of the act, other Federal securities laws—specifically the Securities Act of 1933 and the Securities Exchange Act of 1934—have matured into comprehensive regulatory programs. These laws are the cornerstone of investor protection for all publicly traded corporations. Today, requirements under these laws respecting investor disclosure, standardized accounting procedures, and regulation of the trading markets are sufficient to prevent improper securities practices. These laws apply equally to registered holding companies, and those companies not regulated under the act, and there is simply no continuing justificiation for subjecting registered companies to an additional level of discriminatory Federal regulation.

Also since 1935, public utility regulators at both the State and Federal level have been granted broad regulatory powers. They are now fully able to protect consumers against unreasonable charges in utility rates and to insure continued reliable electric and gas utility service.

Notwithstanding the changes in corporate structure and the proven effectiveness of securities laws and utility regulation, "registered holding companies" must submit every significant business and financing decision to the SEC for approvel. No other sector of American industry is so required to shape its business decisions to meet a standard of good business judgment imposed by a Federal regulatory agency.

The SEC does not directly regulate the greatest portion of gas and electric utlitiy holding companies. But, even though exempt companies and utility operating companies are not directly regulated they are nevertheless subject to broad power of the SEC to revoke their exemptions. They therefore must attempt to conduct their corporate activity within vaguely defined parameters, in order to avoid this extreme and burdensome regulatory sanction.

As you have recognized, Mr. Chairman, it is encumbent upon Congress to review the act and to eliminate regulatory controls that have been overtaken by other regulation or which serve no enduring public policy purpose. While I am confident that on this basis the entire act can be repealed, I recognize that that some compromise is necessary to provide State regulators the assurance that interstate utility holding companies will not act to impair the financial integrity of utility companies. This bill goes a long way toward addressing the stated concerns of consumers and State regulators, while still accomplishing the fundamental objective of reducing unnecessary and burdensome regulatory requirements.

I commend you, Mr. Chairman, for your willingness to undertake the reexamination the Holding Company Act, and for your leadership in seeking reform and modernization of this 48 year old product of the New Deal era. I strongly urge the members of the subcommittee to lend their support to our effort.

Thank you, Mr. Chairman.

Senator D'**Amato**. Today is the second and final day of hearings on S. 1174. I would like to welcome our distinguished witnesses today and call as our first witness Congressman Corcoran. Congressman Corcoran was in the forefront with this issue last year, and I look forward to working with him in the future in dealing with some of the problems that might still need to be resolved with respect to S. 1174. Congressman.

STATEMENT OF TOM CORCORAN, MEMBER, U.S. HOUSE OF REPRESENTATIVES, FROM THE STATE OF ILLINOIS

Mr. **Corcoran**. Thank you very much, Mr. Chairman.

Let me say first that I am pleased to have the opportunity to give my statement from up here. It is very kind of you to afford me that opportunity. I can think of one of your colleagues who would not be too pleased to see me sitting here, however.

Let me also say, Mr. Chairman, that there are a number of important points that I would like to make this morning relative to the legislation which you have introduced here in the Senate and I have introduced in the House along with Congressmen Billy Tauzin (Democrat-Louisiana) and Thomas J. Bliley, Jr. (Republican-Virginia). All three of us are members of the House committee with jurisdiction over the Holding Company Act, the Committee on Energy and Commerce.

I want to emphasize certain aspects of what we are attempting to do in this Congress. By way of summary at the beginning of what I am going to say, let me simply point out that as you well know, Mr. Chairman, we have been working here in the Congress now for quite some time to provide some meaningful reform to the Public Utility Holding Company Act of 1935, and a lot of people who are affected by that important legislation, which has been on the books now for almost 50 years, have been working as well, I think in a very harmonious way in order to bring about some updating of the act and some meaningful reform so that it is really responsive to both the industry and the various consumers that are to be served. I think in a nutshell in the statement I am going to make, Mr. Chairman, I would simply say we have paid very close attention to the concerns that have been expressed by numerous groups in the course of the hearings here in the Senate and in the House of Representatives, and our legislation attempts to respond to those concerns.

As you know, Mr. Chairman, I have been involved for quite some time, like yourself, in attempting to provide some meaningful reform to the Holding Company Act.

As a matter of fact, it has been about 2 years since the beginning of my involvement, and I know yours has been about the same length of time.

IMPACT OF QUESTIONNAIRE

In October 1981, I sent a questionnaire regarding the act to approximately 150 utility executives and the 50 State Public Service

Commissions. I think that the response to that questionnaire indicated in large measure that there was some need for reform, and there was, of course, some indication that no change should be made, and I recognize that in the testimony, Mr. Chairman, before your subcommittee, there may indeed be some reference to our questionnaire. I would simply like to point out that that was over 1½ years ago. Our series of hearings on the legislation which is before the Senate in the form of S. 1174 I think responds to a lot of those concerns and I suspect that today, based on what we have heard already in your hearings, as well as what we have heard informally, we would find widespread support for changing the act.

As a result of the questionnaire, and the staff work that was done in response to it, I introduced legislation on December 15 of 1981, to amend one section, section 3, of the Holding Company Act, and urged that hearings be held in the House to address the possibility of repeal of the entire act.

Last June hearings on my legislation, as well as on legislation calling for repeal of the entire act, were held in the Energy Conservation and Power Subcommittee of the Energy and Commerce Committee. As a result of those hearings, at which industry representatives, the Securities and Exchange Commission, State regulators and various other groups testified, I became convinced that meaningful reform of the Holding Company Act was required in the best interests of investors and consumers, the people whom the Holding Company Act was designed to protect.

Yet it was of utmost importance to me, as indeed I know it was to you, Mr. Chairman, that any reform legislation address in a satisfactory fashion the more meaningful concerns that were raised by those groups that offered testimony in opposition to repeal of the Holding Company Act. Naturally, it is impossible to satisfy everyone. However, and I must stress this point: In my judgment our legislation, S. 1174 and H.R. 2994, which are the products of roughly 6 months of deliberation in search of a fair and equitable compromise, specifically address in all material respects the substantive concerns that were raised at last year's House and Senate hearings.

As such, I think in many respects our legislation represents something of a consensus that should be supported not only by those who favor repeal of the Holding Company Act, but also by those who are opposed to repeal.

Mr. Chairman, I would now like to explain our legislation, pointing to certain of its specific provisions, and illustrate the lengths to which it has gone in seeking to accommodate the real needs of those who in the last Congress opposed repeal of the act. A detailed summary of the legislation appears in my Congressional Record statement accompanying introduction of H.R. 2994, a copy of which is attached.

EXEMPTIONS

Under the current law, the Securities and Exchange Commission is granted in section 3 of the act extremely broad and indeed retroactive authority to condition or revoke a statutory exemption. This has resulted in uncertainty on the part of management as to the regulatory treatment to be expected and, as a result, in some instances a reluctance to deploy fully useful nonutility assets.

In the last Congress, I introduced legislation that would have amended section 3 of the Holding Company Act in a manner that would have eliminated under all circumstances the SEC's ability to condition, withhold or revoke an exemption. S. 1174 and H.R. 2994 offer a reasonable compromise solution.

Our legislation empowers the SEC to withhold or revoke an exemption if it finds upon clear and convincing evidence that the exemption materially adversely affects the system's public utility business. A revocation proceeding or indeed a proceeding to deny an exemption could be initiated by the SEC on its own motion or at the request of any State commission having jurisdiction to regulate the utility operations of an exempt system. Thus, the core issue with respect to exemptions under the act is being squarely addressed in our legislation. Are utility customers being negatively affected by the maintenance of the exemption? If they are, the SEC would still have the authority to revoke retroactively an exemption. Yet management is properly afforded a degree of certainty for corporate planning purposes. Our bill does not change current law which provides that an exemption is automatically granted if the holding company qualifies geographically and the application is made in good faith.

STATE COMMISSION RIGHT TO BOOKS AND RECORDS

Perhaps the most significant feature of our legislation and, I might add, one that is directly responsive to the concerns that were raised last year by many State regulators, addresses the question of State commission access to information concerning the nonutility activities off both exempt and registered holding companies.

As you know, Mr. Chairman, in the hearings in the House last year and certainly in the hearings conducted by your subcommittee, there were numerous questions raised about the ability of the State public utility commissions to get the information they would need. I know you particularly, Mr. Chairman, were responsive to those concerns in the cross-examination of people who were raising those issues, and I think that the legislation that is before us provides adequate opportunity, in fact, a Federal right, for the State public utility commissions to get access to that information in order to make sure that there wouldn't be the kind of cross-subsidization that was raised as a problem.

Unlike existing law, S. 1174 actually creates a new, Federally enforceable right by which the State commissions could gain access to the books, records, and accounts of the nonutility activities of such holding companies.

Such a right should provide for more effective State regulation, and, therefore, should reduce significantly any possibilities for cross-subsidization, a matter I would like to address in more detail later.

Additionally, the bill creates general authority in the SEC to require reports on the nonutility activities of both exempt and registered systems to facilitate State commission monitoring of diversified activities. State commissions are expressly provided the opportunity to apply to the SEC to require such reporting. Thus, the legislation creates the mechanisms for the States, backed by Federal authority, to regulate utility companies organized under a holding company structure. This entire section represents a rather substantial compromise from the proposals that were considered in the last Congress.

Mr. Chairman, I have in my prepared statement some additional comments I would like to be made a part of the record dealing with the financing of the registered systems and the nonutility business activities of registered systems. But I don't think it is necessary to take the time this morning to read that.

Senator D'AMATO. Your entire statement will be put into the record, Congressman.

[Prepared statement of Mr. Corcoran follows:]

TESTIMONY OF
CONGRESSMAN TOM CORCORAN (R-IL)

SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES

JUNE 15, 1983

MR. CHAIRMAN, I COMMEND YOU FOR YOUR LEADERSHIP IN THE SENATE IN SEEKING REFORM OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, AND I AM QUITE PLEASED THAT YOU HAVE GIVEN THIS IMPORTANT ISSUE SUCH HIGH PRIORITY ON YOUR SUBCOMMITTEE'S LEGISLATIVE CALENDAR.

TOGETHER WITH MY DISTINGUISHED COLLEAGUES, CONGRESSMEN TAUZIN (D-LA) AND BLILEY (R-VA), I INTRODUCED LEGISLATION ON MAY 12 IN THE HOUSE, H.R.2994, THAT IS IDENTICAL TO YOUR BILL, S.1174. I THINK THAT SUCH LEGISLATION IS NOTEWORTHY IN THAT IT PROVIDES MEANINGFUL REFORM OF THE HOLDING COMPANY ACT WHILE AT THE SAME TIME MAINTAINING THE IMPORTANT PROTECTIONS THAT THE ACT AFFORDS TO INVESTORS AND CONSUMERS. THEREFORE, I TESTIFY HERE THIS MORNING IN FAVOR OF S.1174, AND I URGE ITS QUICK PASSAGE.

AS YOU KNOW, I HAVE BEEN SERIOUSLY INTERESTED IN REFORM OF THE HOLDING COMPANY ACT SINCE OCTOBER 1981 WHEN I SENT A QUESTIONNAIRE REGARDING THE ACT TO APPROXIMATELY 150 UTILITY EXECUTIVES AND EACH OF THE 50 STATE PUBLIC SERVICE COMMISSIONS. SHORTLY AFTER THE RETURN OF THE QUESTIONNAIRE RESPONSES, I INTRODUCED LEGISLATION ON DECEMBER 15, 1981, TO AMEND ONE SECTION

(Section 3) of the Holding Company Act and urged that hearings be held in the House to address the possibility of repeal of the entire Act. Last June, hearings on my legislation, as well as on legislation calling for repeal of the entire Act, were held in the Energy Conservation and Power Subcommittee of the Energy and Commerce Committee. As a result of those hearings, at which industry representatives, the Securities and Exchange Commission, state regulators and various other groups testified, I became convinced that meaningful reform of the Holding Company Act was required in the best interests of investors and consumers, the people whom the Holding Company Act was designed to protect.

Formulation of Consensus

Yet, it was of the utmost importance to me, as, indeed, I know it was to you, that any reform legislation address in a satisfactory fashion the more meaningful concerns that were raised by those groups that offered testimony in opposition to repeal of the Holding Company Act. Naturally, it is impossible to satisfy everyone. However, and I must stress this point: in my judgment, our legislation, S.1174 and H.R. 2994, which are the products of roughly six months of deliberation in search of a fair and equitable compromise, specifically address in all material respects the substantive concerns that were raised at last year's House and Senate hearings. As such, I think in many respects our legislation represents something of a consensus that should be

SUPPORTED NOT ONLY BY THOSE WHO FAVOR REPEAL OF THE HOLDING COMPANY ACT, BUT ALSO BY THOSE WHO ARE OPPOSED TO REPEAL.

MR. CHAIRMAN, I WOULD NOW LIKE TO EXPLAIN OUR LEGISLATION, POINTING TO CERTAIN OF ITS SPECIFIC PROVISIONS, AND ILLUSTRATE THE LENGTHS TO WHICH IT GOES IN SEEKING TO ACCOMMODATE THE REAL NEEDS OF THOSE WHO IN THE LAST CONGRESS OPPOSED REPEAL OF THE ACT. A DETAILED SUMMARY OF THE LEGISLATION APPEARS IN MY CONGRESSIONAL RECORD STATEMENT ACCOMPANYING INTRODUCTION OF H.R.2994, A COPY OF WHICH IS ATTACHED.

EXEMPTIONS

UNDER THE CURRENT LAW, THE SECURITIES AND EXCHANGE COMMISSION IS GRANTED IN SECTION 3 OF THE ACT EXTREMELY BROAD AND, INDEED, RETROACTIVE AUTHORITY TO CONDITION OR REVOKE A STATUTORY EXEMPTION. THIS HAS RESULTED IN UNCERTAINTY ON THE PART OF MANAGEMENT AS TO THE REGULATORY TREATMENT TO BE EXPECTED AND, AS A RESULT, IN SOME INSTANCES, A RELUCTANCE TO DEPLOY FULLY USEFUL NON-UTILITY ASSETS. IN THE LAST CONGRESS, I INTRODUCED LEGISLATION THAT WOULD HAVE AMENDED SECTION 3 OF THE HOLDING COMPANY ACT IN A MANNER THAT WOULD HAVE ELIMINATED UNDER ALL CIRCUMSTANCES THE SEC'S ABILITY TO CONDITION, WITHHOLD OR REVOKE AN EXEMPTION. S.1174 AND H.R.2994 OFFER A REASONABLE COMPROMISE SOLUTION.

OUR LEGISLATION EMPOWERS THE SEC TO WITHHOLD OR REVOKE AN EXEMPTION IF IT FINDS UPON CLEAR AND CONVINCING EVIDENCE

THAT THE EXEMPTION MATERIALLY ADVERSELY AFFECTS THE SYSTEM'S PUBLIC UTILITY BUSINESS. A REVOCATION PROCEEDING OR, INDEED, A PROCEEDING TO DENY AN EXEMPTION COULD BE INITIATED BY THE SEC ON ITS OWN MOTION OR AT THE REQUEST OF ANY STATE COMMISSION HAVING JURISDICTION TO REGULATE THE UTILITY OPERATIONS OF AN EXEMPT SYSTEM. THUS, THE CORE ISSUE WITH RESPECT TO EXEMPTIONS UNDER THE ACT IS BEING SQUARELY ADDRESSED. ARE UTILITY CUSTOMERS BEING NEGATIVELY AFFECTED BY THE MAINTENANCE OF THE EXEMPTION? IF THEY ARE, THE SEC WOULD STILL HAVE THE AUTHORITY TO REVOKE RETROACTIVELY AN EXEMPTION. YET, MANAGEMENT IS PROPERLY AFFORDED A DEGREE OF CERTAINTY FOR CORPORATE PLANNING PURPOSES. OUR BILL DOES NOT CHANGE CURRENT LAW WHICH PROVIDES THAT AN EXEMPTION IS AUTOMATICALLY GRANTED IF THE HOLDING COMPANY QUALIFIES GEOGRAPHICALLY AND THE APPLICATION IS MADE IN GOOD FAITH.

STATE COMMISSION RIGHT TO BOOKS AND RECORDS

PERHAPS THE MOST SIGNIFICANT FEATURE OF OUR LEGISLATION, AND, I MIGHT ADD, ONE THAT IS DIRECTLY RESPONSIVE TO THE CONCERNS THAT WERE RAISED LAST YEAR BY MANY STATE REGULATORS, ADDRESSES THE QUESTION OF STATE COMMISSION ACCESS TO INFORMATION CONCERNING THE NON-UTILITY ACTIVITIES OF BOTH EXEMPT AND REGISTERED HOLDING COMPANIES. UNLIKE EXISTING LAW, S.1174 ACTUALLY CREATES A NEW, FEDERALLY ENFORCEABLE RIGHT BY WHICH THE STATE COMMISSIONS COULD GAIN ACCESS TO THE BOOKS, RECORDS AND ACCOUNTS OF THE NON-UTILITY ACTIVITIES OF SUCH HOLDING COMPANIES.

Such a right should provide for more effective state regulation, and, therefore, should reduce significantly any possibilities for cross-subsidization, a matter I would like to address in more detail later. Additionally, the bill creates general authority in the SEC to require reports on the non-utility activities of both exempt and registered systems to facilitate state commission monitoring of diversified activities. State commissions are expressly provided the opportunity to apply to the SEC to require such reporting. Thus, the legislation creates the mechanisms for the states, backed by federal authority, to regulate utility companies organized under a holding company structure. This entire section represents a rather substantial compromise from the proposals that were considered in the last Congress.

Financing of Registered Systems

A third major feature of our legislation concerns SEC review of the capital raising activities of registered holding companies. Essentially, unlike repeal, S.1174 maintains SEC review of the financing plans of registered companies while at the same time ensuring that such SEC action will occur within 20 days. The SEC could still disapprove an issue, or impose conditions on its approval, if such action were necessary to prevent an unreasonable economic risk to investors or consumers. The bill preserves the existing opportunity of a state to raise before the SEC claims that the issue or plan violates state law. If such an

OBJECTION IS RAISED, THE SEC COULD NOT APPROVE THE ISSUE OR THE PLAN UNTIL IT IS SATISFIED THAT COMPLIANCE WITH STATE LAW HAS BEEN ACCOMPLISHED OR WILL BE EFFECTED. MOREOVER, IF A REGISTERED HOLDING COMPANY FILES WITH THE SEC FOR APPROVAL OF A TWO-YEAR FINANCING PLAN, CONTEMPORANEOUS NOTICE OF SUCH FILING MUST BE GIVEN TO A JURISDICTIONAL STATE COMMISSION. THUS, COMPROMISES HAVE BEEN MADE CONCERNING REGULATION OF THE FINANCIAL TRANSACTIONS OF REGISTERED HOLDING COMPANIES AS WELL.

NON-UTILITY BUSINESS ACTIVITIES OF REGISTERED SYSTEMS

SIMILARLY, THE PROPOSED REVISIONS IN THE HOLDING COMPANY ACT'S RESTRICTIONS ON THE TYPES OF BUSINESSES THAT REGISTERED HOLDING COMPANIES CAN ENTER REFLECT A DESIRE TO ENSURE THAT MANAGERS WILL PURSUE DIVERSIFIED ACTIVITIES, IF AT ALL, AT A MEASURED PACE AND IN A PRUDENT MANNER. S.1174 WOULD PERMIT REGISTERED SYSTEMS, IN ADDITION TO ANY INVESTMENT ALREADY APPROVED BY THE SEC, TO MAKE ADDITIONAL NON-UTILITY INVESTMENT WITHOUT SEC APPROVAL UP TO TEN PERCENT OF THE SYSTEM'S ASSETS. WHEN THE TEN PERCENT THRESHOLD IS REACHED, NO FURTHER DIVERSIFICATION COULD OCCUR EXCEPT WITH SPECIFIC SEC PERMISSION OR CONSISTENT WITH A DIVERSIFICATION PLAN WHICH ITSELF IS SUBJECT TO SEC DISAPPROVAL. STATE COMMISSIONS MUST BE GRANTED CONTEMPORANEOUS NOTICE OF SUCH FILINGS AND ARE EXPRESSLY AFFORDED THE OPPORTUNITY TO SEEK SEC DISAPPROVAL OF A SPECIFIC INVESTMENT OR OF THE DIVERSIFICATION PLAN. THE SEC WOULD BE REQUIRED TO DISAPPROVE SUCH A FILING IF IT

WERE LIKELY TO RESULT IN INCREASED COSTS TO CONSUMERS OR IMPAIRMENT OF PUBLIC UTILITY SERVICE. THE BILL ALSO GRANTS THE SEC AUTHORITY TO REQUIRE DIVESTITURE OF A NON-UTILITY INVESTMENT IF THE SEC FINDS UPON CLEAR AND CONVINCING EVIDENCE THAT THE NON-UTILITY ACTIVITIES MATERIALLY ADVERSELY AFFECT THE SYSTEM'S PUBLIC UTILITY BUSINESS. THUS, HERE AGAIN, THE PROTECTIONS THAT THE CURRENT ACT EXTENDS TO CONSUMERS ARE BEING MAINTAINED WHILE THE NECESSARY REGULATORY REFORM OF A 48-YEAR OLD STATUTE IS BEING ACCOMPLISHED.

STRENGTHENING OF ANTI-MERGER PROVISIONS

ANOTHER SIGNIFICANT FEATURE OF THE LEGISLATION STRENGTHENS THE SEC'S AUTHORITY TO PREVENT NON-UTILITY ENTERPRISES FROM SUPERIMPOSING THEMSELVES ON A UTILITY. MR. CHAIRMAN, AS YOU QUITE PROPERLY POINTED OUT IN YOUR STATEMENT ACCOMPANYING INTRODUCTION OF THE BILL, THIS PROVISION IS DIRECTLY RESPONSIVE TO THE CONCERNS EXPRESSED LAST YEAR BY STATE REPRESENTATIVES AND CONSUMER ORGANIZATIONS. THEIR CONCERN WAS THAT REPEAL, OR SIGNIFICANT MODIFICATION OF SECTION 9 OF THE ACT WHICH, AS YOU KNOW, OUR LEGISLATION LEAVES UNCHANGED, WOULD REMOVE AN IMPORTANT SHIELD THAT PROTECTS UTILITY COMPANIES FROM BECOMING THE TARGETS OF ACQUISITION-MINDED AND AGGRESIVE CONGLOMERATES. THIS TYPE OF ACTIVITY CLEARLY IS NOT IN THE PUBLIC INTEREST, AND OUR LEGISLATION PROTECTS AGAINST IT.

ALTHOUGH MUCH OF THE "REGULATORY UNDERBRUSH" HAS BEEN THINNED, THE BILL CONTINUES TO PROVIDE THE SEC WITH AUTHORITY TO PROTECT THE FINANCIAL INTEGRITY OF HOLDING COMPANY SYSTEMS BY REGULATING SUCH INTERCOMPANY TRANSACTIONS AS THE DECLARATION OF DIVIDENDS, THE EXTENSION OF CREDIT AND TRANSACTIONS AMONG AFFILIATES. ONCE AGAIN, THE INTERESTS OF CONSUMERS HAVE BEEN PROTECTED.

EFFECTS OF RCS AND CACS PROGRAMS ON CONTRACTORS

BEFORE CONCLUDING, AS I MENTIONED EARLIER, I WANT TO ADDRESS THE QUESTION OF CROSS-SUBSIDIZATION AND, MORE SPECIFICALLY, THE TESTIMONY THAT HAS BEEN DELIVERED BY SOME CONTRACTORS. AT THE HOUSE HEARINGS IN THE LAST CONGRESS, TESTIMONY WAS OFFERED BY THE NASSAU COUNTY, NEW YORK, ASSOCIATION OF PLUMBING-HEATING-COOLING CONTRACTORS TO THE EFFECT THAT REPEAL OF THE HOLDING COMPANY ACT WOULD HURT THEIR MEMBERSHIP. SIMILAR TESTIMONY WAS OFFERED IN THE SENATE. IT IS MY UNDERSTANDING THAT AT BOTH THE HOUSE AND SENATE HEARINGS, IT WAS POINTED OUT RATHER CLEARLY THAT THEIR CONCERNS STEMMED NOT FROM REPEAL OF THE HOLDING COMPANY ACT WHICH NOW PERMITS DIVERSIFICATION BY UTILITIES INTO ENERGY CONSERVATION OR RELATED AREAS THAT THE CONTRACTORS CONSIDER IN THE INTERESTS OF FAIR COMPETITION WITHIN THEIR EXCLUSIVE DOMAIN, BUT RATHER FROM THE RESIDENTIAL CONSERVATION SERVICE AND THE COMMERCIAL AND APARTMENT CONSERVATION SERVICE PROGRAMS. IN MY JUDGMENT SUCH PROGRAMS SHOULD BE REPEALED, AND ON MARCH 23 OF THIS

YEAR I JOINED IN INTRODUCING H.R.2283, THE "ENERGY CONSUMER REGULATORY REFORM ACT OF 1983" WHICH, AMONG OTHER THINGS, DOES JUST THAT. TO PUT IT QUITE SIMPLY, I DO NOT BELIEVE THAT OUR LEGISLATION AFFECTS THE CONTRACTORS ONE WAY OR THE OTHER. BUT I WILL PLEDGE TODAY TO WORK WITH THEM IN THE HOUSE ON ISSUES THAT SHOULD PROPERLY BE THEIR CONCERN.

MOREOVER, THE OPTIMUM STRUCTURE FOR A UTILITY TO USE IN UNDERTAKING ITS DIVERSIFICATION ACTIVITIES WOULD BE TO FORM A HOLDING COMPANY WITH SEPARATE CORPORATE SUBSIDIARIES FOR ITS UTILITY AND NON-UTILITY BUSINESSES. THIS WOULD ENSURE A DISTINCT SEPARATION OF UTILITY AND NON-UTILITY ASSETS AND, THEREFORE, FACILITATE EFFECTIVE STATE REGULATION OF THE UTILITY BUSINESS. AS I SUGGESTED EARLIER, EFFECTIVE STATE REGULATION WOULD BE THE BEST MEANS OF ENSURING THAT THE UTILITY BUSINESS IS NOT USED TO CROSS-SUBSIDIZE THE NON-UTILITY BUSINESS. THE CHANGES PROPOSED IN S.1174 ACTUALLY FACILITATE THE USE OF SUCH A CORPORATE STRUCTURE, AND, AS I HAVE ALREADY MADE CLEAR, SECTION 3A OF THE BILL PROVIDES THE STATE COMMISSIONS WITH A FEDERALLY ENFORCEABLE RIGHT TO ACCESS TO THE BOOKS AND RECORDS OF NON-UTILITY AFFILIATES. THIS GUARANTEES THE STATE COMMISSIONS SUFFICIENT INFORMATION TO PREVENT CROSS-SUBSIDIZATION.

CONCLUSION

MR. CHAIRMAN, I CONSIDER THE PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983 TO BE A REASONABLE, RESPONSIBLE REGULATORY REFORM PACKAGE THAT HAS BEEN SPECIFICALLY TAILORED TO PROTECT INVESTORS AND CONSUMERS WHILE REDUCING UNDUE REGULATORY BURDENS. AS SUCH, I URGE ITS QUICK PASSAGE. I WOULD LIKE TO THANK YOU FOR THE OPPORTUNITY TO TESTIFY BEFORE THIS DISTINGUISHED SUBCOMMITTEE. THIS CONCLUDES MY PREPARED REMARKS.

Mr. CORCORAN. Thank you very much, Mr. Chairman.

Let me just dwell on a couple of other points which I think do bear emphasis.

No. 1, in that respect is the strengthening of the antimerger provisions which our legislation would create.

Another significant feature of the legislation strengthens the SEC's authority to prevent nonutility enterprises from superimposing themselves on a utility. As you properly pointed out, Mr. Chairman, in your statement accompanying introduction of the bill, this provision is directly responsive to the concerns expressed last year by State representatives and consumer organizations. Their concern was that repeal or significant modification of section 9 of the act, which, as you know, our legislation leaves unchanged, would remove an important shield that protects utility companies from becoming the targets of acquisition-minded and aggressive conglomerates. This type of activity clearly is not in the public interest, and our legislation protects against it.

Although much of the "regulatory underbrush" has been thinned, the bill continues to provide the SEC with authority to protect the financial integrity of holding company systems by regulating such intercompany transactions as the declaration of dividends, the extension of credit, and transactions among affiliates. Once again, the interests of consumers have been protected.

In this respect the bill deals with the concerns that many small independent contractors, plumbers, and others, raised during the course of the testimony on our legislation last year.

As I mentioned earlier, I want to address that question of cross-subsidization and more specifically the testimony that has been delivered by some contractors.

At the House hearings in the last Congress, testimony was offered by the Nassau County New York Association of Plumbing, Heating and Cooling Contractors to the effect that repeal of the Holding Company Act would hurt their membership. Similar testimony was offered in the Senate. It is my understanding that at both the House and Senate hearings, it was pointed out rather clearly that their concerns stemmed not from repeal of the Holding Company Act, which now permits diversification by utilities into energy conservation or related areas that the contractors consider in the interest of fair competition within their exclusive domain, but rather from the residential conservation service and the commercial and apartment conservation service programs. In my judgment such programs should be repealed, and on March 23 of this year I joined in introducing H.R. 2283, the Energy Consumer Regulatory Reform Act of 1983 which, among other things, does just that. To put it quite simply, I do not believe that our legislation affects the contractors one way or the other. But I will pledge today to work with them in the House on issues that should properly be their concern.

Moreover, the optimum structure for a utility to use in undertaking its diversification activities would be to form a holding company with separate corporate subsidiaries for its utility and nonutility businesses. This would insure a distinct separation of utility and nonutility assets and, therefore, facilitate effective State regulation of the utility business.

As I suggested earlier, efffective State regulation would be the best means off insuring that the utility business is not used to cross-subsidize the nonutility business. The changes proposed in S. 1174 actually facilitate the use of such a corporate structure, and, as I have already made clear, section 3A of the bill provides the State commissions with a federally enforceable right to access to the books and records and other important information of the nonutility afffiliates. This guarantees the State commissions sufficient information to prevent cross-subsidization.

Let me say, Mr. Chairman, in conclusion that I think working together with people in the Congress, working together with representatives of the industry that is directly involved with the Public Utility Holding Company Act and others who are affected by it, we have achieved, I think, a good consensus on the legislation that is before us.

I know the State regulators have testified already in your hearings that they are within an eyelash of supporting our compromise legislation. There may still be some particular concerns and I certainly pledge to you my willingness to work with you and others to make sure all of those concerns are addressed in a meaningful way so we can have some updating and some meaningful reform to the Public Utility Holding Company Act that would make it responsive to the current concerns of both investors and consumers.

Senator D'AMATO. Thank you very much, Mr. Corcoran. I am particularly gratiffied with your outstanding work on the House side. In yesterday's testimony the small independent contractors once again expressed their concerns about the effects that S. 1174 might have on fair competition. Specifically, they fear the subsidization of nonutility activities by utilities.

I think that there is an existing problem, and that we in the Congress should deal with it. We certainly have a great deal of responsibility in seeing to it that we do not deter the small business community. I think we may be able to tailor S. 1174 in such a manner that it would take care of some of the abuses that are now taking place.

It is my goal to hold some hearings in the Small Business Committee and to address this problem, if possible, in S. 1174 or in other legislation or maybe within the Small Business Act itself. I therefore look forward to your input in this regard for it is perceived, rightfully or wrongffully, that cross subsidization or unfair competition might be exacerbated by the passage of S. 1174.

Mr. CORCORAN. Mr. Chairman, I certainly agree with your point that we want to respond to the concerns of the independent contractors and any other organizations that feel that they would in some way be adversely affected by the passage of our legislation.

As you correctly point out, it is my judgment and I think it is a judgment that will be borne out in the testimony before your subcommittee, that the change with respect to the Holding Company Act which we are suggesting would not in any way change existing law with respect to the driving forces which now cause the utility companies to get into energy audits and things of that nature. That happens to be emanating from other statutes such as the one that I mentioned.

Nonetheless, I think, as you suggest, Mr. Chairman, there may indeed be some ways that we can alleviate the concerns that these organizations have, and I certainly pledge my cooperation with them and with you to see that that happens in the legislation that will ultimately be enacted by the Congress.

[From the Congressional Record—May 12, 1983]

PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983

The **SPEAKER** pro tempore. Under a previous order of the House, the gentleman from Illinois (Mr. **CORCORAN**) is recognized for 10 minutes.

Mr. **CORCORAN**. Mr. Speaker, with my distinguished colleagues, Mr. **TAUZIN** and Mr. **BLILEY**, I am today introducing the Public Utility Holding Company Act Amendments of 1983. This legislation reforms the Public Utility Holding Company Act of 1935 while continuing the very necessary protections that the act offers to investors and consumers.

In the last Congress, on December 15, 1981, I introduced legislation (H.R. 5220) to amend one section of the Holding Company Act while other Members, including Mr. **TAUZIN**, introduced legislation to repeal the Holding Company Act in its entirety, a position advocated by the Securities and Exchange Commission. During the last Congress, hearings were held on this legislation by the Energy and Commerce Committee's Energy Conservation and Power Subcommittee, of which I was a member. As a result of these hearings, at which industry representatives, the SEC, State regulators and various other groups testified, I became convinced that, at the very least, meaningful reform of the Holding Company Act was required in the best interests of investors and consumers, the people whom the Holding Company Act was designed to protect.

Prior to the hearings by the Senate and House last Congress, I initiated a major survey of the 50 public utility commissions and over 100 utility holding companies and independent operating companies with respect to the Holding Company Act. After that October 1981 survey, I introduced H.R. 5220, the Public Utility Financial Reform Act on December 15. The bill being introduced today takes into full consideration the results of my 1981 survey and the testimony from the June 9, 1982, hearing by Chairman **OTTINGER**'s subcommittee. My survey, including all of the responses, was included in the subcommittee hearing record (serial No. 97-165).

The Public Utility Holding Company Act Amendments of 1983 were crafted so as to reform a very technical statute in a manner that addresses in a satisfactory fashion the concerns that were raised by those groups that testified at Chairman **OTTINGER**'s hearings in opposition to repeal of the Holding Company Act. Naturally, it is impossible to satisfy everyone. However, and I must stress the point that, in my judgment, the legislation we are introducing today, which is the product of roughly 6 months of deliberation, specifically addresses in all material respects the substantive concerns that were raised at last year's hearings. As such, I think in many respects it represents something of a consensus that should be supported not only by those who favor repeal of the Holding Company Act, but also by those who oppose such repeal.

The Holding Company Act was passed in 1935 to correct a series of abuses by electric and gas utility holding companies, notably excessive pyramiding of corporate structures and stock watering. At that time, a handful of holding companies controlled virtually the entire utility business in the Nation. These holding companies operated in disparate parts of the country and were not subject to effective State regulation.

In the view of the Congress, the power and interstate character of these holding companies rendered State control over such abuses ineffective and required that authority over them be conferred upon the SEC. The principal purpose of the Holding Company Act, as noted in the legislative history, was to insure effective State regulation by reorganizing these holding companies into geographically contiguous units. Virtually all of the questionable practices the Holding Company Act was designed to correct were securities and accounting ones, not unique to the utility industry. As such, they probably would have been eliminated over time by the then-new Securities Act of 1933 and the Securities Exchange Act of 1934, both of which turned out to be far more effective than anticipated. Accounting standards and practices have improved dramatcially since the mid-1930's. Moreover, the regulation of public utilities on the State level is considerably more effective today than when the Holding Company Act was passed, since State utility laws have now evolved into strong, comprehensive regulatory systems. Thus, present Federal and State regulation is drastically different from that of the early 1930's, and there is little likelihood those problems would recur if the Holding Company Act were reformed.

Identical legislation (S. 1174) was introduced on April 28 in the Senate by Senators D'Amato and Johnston. It is my understanding that Senator D'Amato's Securities Subcommittee intends to hold hearings on such legislation on May 25 and 26. I hope that this leglisation will also be the subject of early hearings in the House. It may well be appropriate to consider other relevant Federal laws, such as Federal Power Act, in this connection. I was particularly pleased to hear of the interest in this issue expressed by Energy and Commerce Committee subcommittee Chairmen Ottinger and Wirth at last week's full committee mark-up of the SEC authorization legislation. I look forward to working with my fellow Energy and Commerce Committee members as we pursue this issue.

Before concluding, at the hearings that were held in the last Congress on repeal of the Holding Company Act, testimony was offered by the Nassau County Association of Plumbing-Heating-Cooling Contractors to the effect that repeal of the Holding Company Act would hurt their membership. At those hearings, it was pointed out rather clearly that their concerns stemmed not from repeal of the Holding Company Act which now permits diversification by utilities into energy conservation, but rather from the Residential Conservation Service and the Commercial and Apartment Conservation Service programs. In my judgment such programs should be repealed, and I am an original cosponsor of H.R. 2283 which, among other things, does just that. I joined Mr. Moorhead and others on March 23 of this year in introducing H.R. 2283, the Energy Consumer Regulatory Reform Act of 1983.

Naturally, I share concerns about anticompetitive behavior in all segments of American industry. That, of course, is the issue that our antitrust laws properly address.

Mr. Speaker, I consider the Public Utility Holding Company Act amendments of 1983 to be a reasonable, responsible regulatory reform package that has been specifically tailored to protect investors and consumers while reducing undue regulatory burdens. Particularly as a member of the Energy and Commerce Committee, I look forward to addressing this matter in the ensuing months.

By Mr. Corcoran (for himself, Mr. Tauzin, and Mr. Bliley):

H.R. 2994. A bill to amend the Public Utility Holding Company Act of 1935 to simplify its administration, to insure State regulatory access to necessary information, to remove certain regulatory restrictions on business practices where such restrictions are no longer necessary to the protection of investors and consumers, and for other purposes; to the Committee on Energy and Commerce.

[From the Congressional Record—Extensions of Remarks]

Explanation of Public Utility Holding Company Act Amendments of 1983

HON. TOM CORCORAN OF ILLINOIS, IN THE HOUSE OF REPRESENTATIVES, THURSDAY, MAY 12, 1983

Mr. Corcoran. Mr. Speaker, for the benefit of our colleagues, I would like to insert in the Record an explanation of a bill I introduced today, the Public Utility Holding Company Act Amendments of 1983. The explanation follows:

1. PROPOSED MODIFICATION OF PROVISIONS GOVERNING EXEMPTIONS

The bill preserves the Act's distinction between registered and exempt holding companies. Exemptions would continue to be available for a holding company, so long as its structure and operations are confined within geographic and other statutorily prescribed limits designed to ensure effective state regulation of the utility business.

Under the bill, the Act's exemptive provisions would be changed in two respects. First, an additional exemption category would be added. This would permit a company whose utility operations are confined to the state in which it is organized and contiguous states, or a holding company that is predominantly a public utility company whose operations do not extend beyond the state in which it is organized and contiguous states, to form a holding company over its utility operations and still gain exemption from the Act. New Section 3(a)(6).

Second, the bill modifies the regulatory mechanism by which an exemption may be withheld, conditioned or revoked. New Section 3(c)-(e). Under current law, the "unless and except" clause in section 3(a) gives the Securities and Exchange Commission ("SEC") extaordinarily broad authority to condition or revoke retroactively a statutory exemption. Thus, management is often uncertain as to the regulatory treatment that it should expect to receive. The bill does not propose to eliminate SEC authority to withhold or revoke a statutory exemption but would confine the SEC's power to revoke a statutory exemption to those circumstances where it can be shown that consumers' interests are negatively affected. Thus, in place of the present "unless and except" clause, the bill would empower the SEC to withhold or revoke an exemption if it found upon clear and convincing evidence that the exemption materially adversely affects the system's public utility business. A revocation proceeding or a proceeding to deny an exemption could be initiated by the SEC on its own motion or at the request of any state commission having jurisdiction to regulate any utility operations of an exempt system. Such state commission would be given contemporaneous notice of an application for exemption.

2. STATE COMMISSION ACCESS TO BOOKS AND RECORDS; STATE COMMISSION MONITORING OF DIVERSIFIED ACTIVITIES

The bill would create for state commissions a new federally enforceable right to gain access to the books, records and accounts of nonutility activities of both exempt and registered companies. The provision expressly addresses a circumstance in which a state commission, in the course of a proceeding, is not satisfied that it has been granted adequate access to the books, records and accounts of a holding company or a nonutility subsidiary. In such an event the state commission is granted a right of action in United States federal district court to secure access to any records it can show to be necessary to the performance of its regulatory responsibilities. New Section 3A(a)-(b).

In addition to this authority with respect to information necessary to a specific proceeding, the bill creates general authority in the SEC to require bienniel reports on the nonutility activities of both exempt and registered systems to facilitate state commission monitoring of diversified activities. State commissions are expressly provided the opportunity to apply to the SEC to require such reporting. As in the case of the access to specific books, records and accounts, conditions would be imposed to safeguard against the unwarranted public disclosure of any confidential business information. New Section 3A(c).

This proposal would create the mechanisms for state commission information gathering, backed by federal authority, that is necessary for effective state regulation of utility companies organized under a holding company structure. The authority with respect to books, records and accounts, confined to circumstances in which specific regulatory need can be demonstrated, well accommodates state regulatory purposes and the legitimate business objective of effective segregation of utility and nonutility operations.

3. FINANCIAL CONTROLS AND CONTROLS ON CAPITAL STRUCTURE

Among the most troublesome of the Act's regulatory requirements are provisions which require registered companies and their subsidiaries to obtain prior SEC approval of each security issuance. The requirement that the SEC approve the specific terms of a company's financings has no parallel in the securities laws which effectively regulate the capital raising activities of other sectors of the utility industry. SEC approval has produced no demonstrable savings to customers of registered systems as compared to those of the majority of utility companies which do not submit the terms of their proposed issues to SEC review.

Though advantages are not always evident, disadvantages are clear. Delays pending SEC review result in missed market opportunities that other firms, free to respond quickly, may translate into lower capital costs. Moreover, the mechanism for review offers no certainty to lenders and investors until such time as the SEC, in its discretion, determines to act. Customers bear any costs of such delay.

The problems posed by these provisions of the Act may be substantially remedied while maintaining SEC review of new financing plans of interstate systems. The primary objective of amendments to this section is to create an automatic mechanism which places most security issues before the SEC for review, but ensures that regulatory action will occur within twenty days after submission to the SEC. The SEC could still disapprove an issue, or impose conditions on its approval, if such action is necessary to prevent an unreasonable economic risk to investors or consumers. Otherwise, the issue would be automatically approved at the end of the twenty day waiting period. New Section 7(b).

A second change of considerable significance creates a statutory opportunity to secure advance aproval of a two-year financing plan. Once the plan clears SEC review a company could time the issuance of securities under the plan to respond to the dictates of the market. New Section 7(b)(3).

With respect to both individual issues subject to review and proposed financing plans, the bill preserves the existing opportunity of a state to raise before the SEC claims that the issue or plan violates state law. If such an objection is raised, the SEC could not approve the issue or the plan until it is satisfied that compliance with state law has been accomplished or will be effected. New Section 7(c).

In addition to these modifications, the bill exempts certain issues from SEC review. Nonutility subsidiary financing will be exempt, although holding company guaranties or assumptions of liability on behalf of nonutility subsidiaries would be subject to review if such guarantees aggregate more than ten percent of the book value of the holding company's securities. Similarly, an exemption for short-term debt issues by the holding company would be provided until such debt issues aggregate ten percent of the book value of the holding company's outstanding securities. Public utility subsidiary financings would remain fully subject to review unless approved by a jurisdictional state commission. New Section 6.

4. INTERCOMPANY FINANCING

As discussed above, the bill would not continue SEC review of securities issues by nonutility subsidiaries of registered holding companies. Nevertheless, the SEC would be authorized to protect the integrity of utility company assets and financial commitments by regulating intercompany transactions. This authority would include: authority to restrict the declaration of dividends by the holding company or any public utility subsidiary. New Section 12(a); authority to restrict extensions of credit by a public utility company to another company in the same holding company system. New Section 12(b); and authority to establish requirements governing any other transaction between a utility company and any affiliate or any other company in the same system. New Section 12(c).

The SEC would also be empowered to restrict sales of utility securities and assets by the holding company. New Section 12(d).

5. DIVERSIFICATION

We have proposed revisions in the Act's controls on diversification to provide both management flexibility and regulatory confidence that managers will pursue diversified activities, if at all, at a measured pace and in a prudent manner.

As presently administered, the Act's controls on diversification consist of two basic elements for registered companies: every investment must be specifically approved by the SEC, and only functionally related investment is tolerated. Our proposal provides for periodic regulatory review of holding company diversification plans.

In response to concerns raised relating to conglomerate mergers, the proposed amendments expand the protections of the current law and provide the SEC with effective power to prevent nonutility enterprises from superimposing themselves on a utility. New Section 9(a)(3).

The proposed amendments would permit registered systems, in addition to any investment already approved by the SEC, to make additional nonutility investments without SEC approval up to ten percent of the system's assets. New Section 9(a), (c).

When the ten percent threshold is reached, no further diversification could occur except with specific SEC permission or consistent with a diversification plan which itself is subject to SEC disapproval. State commissions are expressly afforded the opportunity to seek SEC disapproval of a specific investment or of the diversification plan. New Section 10(g), (h).

The bill also grants SEC authority to require divestiture of a nonutility investment if the SEC finds upon clear and convincing evidence that the nonutility activities materially adversley affect the system's public utility business. New Section 11(b)(1)(B).

6. AFFILIATE TRANSACTIONS

The bill would retain the SEC's authority to regulate contracts for sales of goods and services between a public utility company and sister subsidiaries. This would include retention of existing authority to establish accounting rules by which the SEC determines costs to be allocated among companies for such goods and services. Under the amendments, however, the SEC would be prohibited from allocating to any public utility company any losses or earnings fairly and equitably attributable to nonutility subsidiary transactions with third parties. New Section 13(g).

Also, under this amendment, in order for a nonutility subsidiary to charge a public utility company a price for goods or services above cost, it must apply to the SEC for specific approval. New Section 13(h).

Senator D'AMATO. Thank you very much, Mr. Congressman. We appreciate your work in this area.

We have this morning the Honorable John S. R. Shad, Chairman of the Securities and Exchange Commission.

STATEMENT OF JOHN S. R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

Senator D'AMATO. Mr. Chairman, how are you this morning?

Mr. SHAD. I am fine.

Thank you very much Chairman D'Amato and members of the subcommittee: I appreciate this opportunity to testify in support of the objectives of S. 1174 and to recommend certain modifications, which are intended to clarify and facilitate the SEC's administration of the 1935 Act as amended.

As you know, a year ago the Commission recommended repeal of the act. That recommendation was based on over 1,000 hours of staff analysis of the act's history and application. The Commission concluded that the principal purpose of the 1935 Act, the simplification or elimination of multitiered electric and gas holding companies, was accomplished over 20 years ago and that the act was no longer necessary to prevent recurrence of the practices which led to its enactment.

At one time or another, 223 electric and gas public utility holding companies have been registered under the 1935 Act. Today only 12 are still required to obtain prior Commission approval of their intrasystem transactions, acquisitions, and financings. These 12 companies represent only 20 percent of the Nation's electrical utility assets and 8 percent of our natural gas distribution assets. None of the Nation's other public utility holding companies, telephone, pipeline, transportation, radio, television—water, sewage, or other holding companies—are subject to comparable Federal regulation.

In addition, major economic and regulatory changes since the 1920's preclude the recurrence of such practices. For example, from 1902 to 1927, electric generation capacity doubled every 5 years. Electric utilities were a dynamic growth industry. Improving technology permitted voluntary rate reductions, which expanded demand. Utilities were also benefiting from the introduction of new electrical appliances and equipment, as well as rising urban populations, as millions moved to the cities from the farms.

These favorable fundamentals resulted in rapid growth and high rates of return on the capital invested in generation facilities. Investment bankers and others were able to pyramid paper profits through highly leveraged, multitiered holding companies. State and Federal regulations and disclosure requirements were lax to nonexistent. There were no uniform accounting standards or requirements. Assets were reappraised upward to facilitate financings. The investing public was unsophisticated. Credit was cheap, and margin requirements were low.

COMMISSION REQUIRES ACCURATE DISCLOSURE

Today, sophisticated institutional investors account for 70 percent of the market in listed stocks and half of the over-the-counter market. Accounting standards are uniform and highly refined. The Commission requires full and accurate disclosure by all issuers and surveils the securities industry and the accounting profession. The Federal Energy Regulatory Commission and the State commissions have pervasive authority over public utility rates, finances, operations, and accounting standards and formats. Investor advisory services publish objective, qualitative ratings of utility securities. Parent companies debt securities are generally rated lower than their subsidiaries debt securities because they are riskier. Credit is expensive and margin requirements are high.

Investment banking and brokerage firms are highly regulated today. Electric and gas utilities are far from glamorous industries. Neither their image nor their economics will support the highly leveraged, multitiered holding companies of half a century ago.

Whether or not these 12 holding companies financings are subject to SEC prior approval, these companies are and will continue to be subject to the SEC's registration and reporting requirements, and their operating subsidiaries are and will continue to be subject to the pervasive rate and other regulations of FERC and the State commissions.

Some believe that the SEC regulates public utility rates. This has never been the case. The SEC regulates only the intrasystem transactions, acquisitions and financings of 12 electric and gas public utility holding companies.

Over the years there has been a serious deterioration in the financial condition of these companies. Some have been forced to do dilutionary equity financings in order to hold their bond and credit ratings. This is like eating your seed corn. It provides a meal at the expense of next year's crop.

To the extent that these 12 companies have to compete for capital to replace and modernize their facilities, the present regulations place them at a disadvantage with all other publicly owned corporations. Reducing these companies regulatory burdens is not a panacea, but it will increase their financing, acquisition and other alternatives—alternatives which all other corporations, including other utility holding companies, are permitted to pursue with a view to improving their profitability and strengthening their financial condition.

For these reasons the SEC believes that today the act inhibits the ability of these companies to improve their services to consumers, and that it should be repealed. However, the Commission appreciates that some State utility commissioners and others believe interstate holding companies require continued Federal involvement in their financings, acquistions and intrasystem transactions. S. 1174 is a compromise. It would reduce the burden on these companies ability to compete in the public marketplace for capital and acquisitions, but retain the Commission's oversight and afford the State commissions a forum in which they may intercede directly.

S. 1174 REDUCES REGULATORY BURDENS IN FOUR AREAS

The first is financing and controls on capital structure. Under S. 1174 holding company system financings would continue to be subject to Commission review, except those by nonutility subsidiaries, and those by utility subsidiaries approved by jurisdictional State commissions. Removing the Commission's prior review of these financings would improve the ability of such subsidiaries to compete for capital in the marketplace.

The Commission suggests the following modifications to the bill in order to clarify its responsibilities. Under S. 1174, holding company financings would continue to be subject to Commission review and must be disapproved if they pose "an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public utility companies and holding company systems which are not subject to regulation under sections 6, 7, and 12."

The Commission believes the "unreasonable economic risk to investors or consumers" standard should be revised to reflect the significant changes in regulations and the securities markets since enactment of the 1935 Act. The concepts of disclosure and financial reporting under the Securities Act of 1933 and the Securities Exchange Act of 1934 are highly sophisticated. There is a general consensus that the provisions of the securities laws provide significant investor protection. The Commission sees no continuing basis for believing that investors in these 12 companies require more protection than investors in the other 9,000 publicly-held corporations. Given full disclosure, what constitutes an "unreasonable economic risk" should be decided by investors, as in the case of all other investments.

With respect to "unreasonable economic risk" to consumers, some State utility commissions are concerned that they cannot regulate directly financings by interstate systems. It is therefore recommended that these 12 companies be required to file simultaneously with the SEC and the jurisdictional State commissions their nonexempt financings and diversification plans. The State commissions would then have an opportunity to intercede and be heard. And this is the most important point of the recommendation: The Commission recommends its authority to disapprove be limited to cases in which a State commission objects and can demonstrate in accordance with S.1174 that the proposal would have a material detrimental impact on public utility customers. In other words, the State utility commissions would be the applicants in these proceedings to disapprove if they felt it would be harmful to consumers.

Senator D'AMATO. Let me ask you at this point whether or not you believe State public utility commissions have the ability and the manpower required to make those kind of determinations?

Mr. SHAD. My impression is that it varies. There are some States that have very large utility commissions and others that have smaller ones. I think they have the legal authority, that the States can give them that power, and most of them, I believe, do have the power.

Senator D'AMATO. The question is do they have the ability?

Mr. **Shad**. My impression is that they do, in terms of personnel. We haven't done a survey of that, but I would be glad to see if we can come up with some numbers on that.

Senator **D'Amato**. I would appreciate that. I think that is an important consideration because we have come a long way with the State agencies, I think as the Congressman just testified, we are probably in a position, with some minor adjustments to get their approval. I would think if we were to shift the area of responsibility back to the States, giving them the burden of proof, it might change their thinking.

So I think it is important to see whether or not they feel they can adequately undertake this new responsibility.

Mr. **Shad**. We will try to come up with some facts on that.

Senator **D'Amato**. I would appreciate that.

[See page 301 for response to question.]

Mr. **Shad**. I would say one of the rationales for this recommendation is that they are much closer to the scene. The State commissions are the ones that are directly charged with protecting the consumers in their States.

Senator **D'Amato**. For the first time, under S. 1174, State commissions have the ability to get access to books and records of companies where the activities they have undertaken are outside of the scope of the utility business. This is something that heretofore they have not had. There are some who said maybe we didn't go far enough, because they may have to resort to a Federal suit, but I think it is a major step. We are attempting to fashion a compromise here which will afford protection to the consumer, but at the same time create the opportunity for these companies to enter those areas in which they have special abilities and talents.

For example, Brooklyn Union Gas, a company that is not affected by this act, undertook housing restoration projects in substantial portions of Brooklyn. The fact that they are probably one of the largest providers of gas in any area in the Nation is significant; without good housing stock utility companies will be unable to sell their product.

There is a relationship there. They have been a very very positive influence. But were they to come within this act, chances are they would be precluded from undertaking these types of activities. Please continue.

Mr. **Shad**. Yes, that is true.

Mr. Chairman, I have one further suggestion to make this morning. The Commission also recommends that S. 1174 be amended to provide that any issues of State law be resolved by the State courts rather than the SEC, a Federal agency.

In conclusion, I request that the longer statement previously submitted to the committee by the Commission be included in the record.

Senator **D'Amato**. Your entire statement will be included in the record.

Mr. **Shad**. Thank you. That statement contains additional recommendations concerning S. 1174, including some regarding time limits, some of which I think pose great difficulty for both the SEC and the States, as well as making other recommendations beyond those I have highlighted here today.

Thank you.

[The prepared statements of Mr. Shad follow:]

Some believe the SEC regulates public utility rates. This has never been the case. The SEC regulates only the intra-system transactions, acquisitions and financings of 12 electric and gas public utility holding companies.

Over the years there has been a serious deterioration in the financial condition of these companies. Some have been forced to do dilutionary equity financings, in order to hold their bond and credit ratings. This is like eating your seed corn. It provides a meal at the expense of next year's crop.

To the extent that these 12 companies have to compete for capital to replace and modernize their facilities, the present regulations place them at a disadvantage with all other publicly owned corporations. Reducing these companies' regulatory burdens is not a panacea, but it will increase their financing, acquisition and other alternatives -- alternatives which all other corporations, including other utility holding companies, are permitted to pursue with a view to improving their profitability and strengthening their financial condition.

The Commission Supports the Objectives of S. 1174

For the foregoing reasons, the Commission believes that today the Act inhibits the ability of these companies to improve their services to consumers, and that it should

Current Testimony

The Commission continues to support repeal of the 1935 Act. It believes the Act is no longer needed to protect investors and consumers and that it seriously limits the ability of the 12 companies which remain subject to it to compete in the marketplace with other companies for capital and acquisitions.

S. 1174 would reduce such burdens. Accordingly, the Commission supports the objectives of S. 1174 and recommends herein certain modifications which are intended to clarify and facilitate the SEC's administration of the 1935 Act as so amended. The Commission's proposals are consistent with the objectives of S. 1174 to remove unnecessary burdens and to be responsive to the concerns of some state utility commissioners over the regulation of interstate utility financings, acquisitions and intra-system transactions.

The Past and Present Status of the Industry

The principal purpose of the 1935 Act, simplification or elimination of multi-tiered electric and gas holding companies, was accomplished over 20 years ago. At one time or another, 223 electric and gas public utility holding companies have been registered under the 1935 Act. Today, only 12 are still required to obtain prior Commission approval of their intra-system transactions, acquisitions and financings. These 12 companies represent only 20 percent of the Nation's electrical utility assets and 8 percent of our natural gas distribution assets. None of the Nation's other public utility holding companies -- telephone, pipeline, transportation, radio, television, water, sewage or other holding companies -- are subject to comparable Federal regulation.

The economic, industry and regulatory fundamentals which permitted the practices of half a century ago have changed completely. From 1902 to 1927, electrical generation capacity doubled every 5 years. Electric utilities were a dynamic growth industry. Improving technology permitted voluntary rate reductions, which expanded demand. Utilities were also benefitting from the introduction of new electrical appliances and equipment, as well as rising urban populations, as millions moved to the cities from the farms.

These favorable fundamentals resulted in rapid growth and high rates of return on the capital invested in generation facilities. Investment bankers and others were able to pyramid paper profits through highly leveraged, multi-tiered holding companies. State and federal regulations and disclosure requirements were lax to nonexistent. There were no uniform accounting standards or requirements. Assets were reappraised upward to facilitate financings. The investing public was unsophisticated. Credit was cheap, and margin requirements were low.

Today, sophisticated institutional investors account for 70 percent of the market in listed stocks and half of the over-the-counter market. Accounting standards are uniform and highly refined. The Commission requires full and accurate disclosure by all issuers and surveils the securities industry and the accounting profession. The Federal Energy Regulatory Commission and the state commissions have pervasive authority over public utility rates, finances, operations, and accounting standards and formats. Investor advisory services publish objective, qualitative ratings of utility securities. Parent companies' debt securities are generally rated lower than their subsidiaries' debt securities, because they are riskier. Credit is expensive and margin requirements are high.

Investment banking and brokerage firms are highly regulated today. Electric and gas utilities are far from glamorous industries. Neither their image nor their economics will support the highly leveraged, multi-tiered holding companies of half a century ago.

Whether or not these 12 holding companies' financings are subject to SEC prior approval, these companies are and will continue to be subject to the SEC's registration and reporting requirements, and their operating subsidiaries are and will continue to be subject to the pervasive rate and other regulations of FERC and the state commissions.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS REGARDING S. 1174 TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

June 15, 1983

The Securities and Exchange Commission appreciates this opportunity to testify in support of the objectives of S. 1174, and to recommend certain modifications, which are intended to clarify and facilitate the SEC's administration of the 1935 Act as so amended.

1982 Testimony

On June 2, 1982, the Commission testified before this Subcommittee in favor of repeal of the 1935 Act. That testimony was based on over 1,000 staff hours of analysis of the 1935 Act's history and application, and included analysis of the existing and potential state regulation in this area. The Commission concluded that the principal purpose of the 1935 Act -- the simplification or elimination of the multi-tiered electric and gas utility holding companies -- had been accomplished over 20 years ago and that the Act was no longer necessary to prevent recurrence of the practices which led to its enactment. Accordingly, the Commission testified that the burdens of the 1935 Act on utilities, their investors and consumers, and the nation's taxpayers were no longer justified.

be repealed. However, the Commission appreciates that some state utility commissioners believe interstate holding companies require continued federal involvement in their financings, acquisitions and intra-system transactions. S. 1174 is a compromise. It would reduce the burdens on these companies' ability to compete in the public marketplace for capital and acquisitions, but retain the Commission's oversight and afford the state commissions a forum in which they may intercede directly.

The following discussion evaluates the bill in light of its objectives. It also presents ways in which the legislation should be improved to clarify the Commission's role.

1. Financing and Controls on Capital Structure

Under S. 1174, holding company system financings would continue to be subject to Commission review, except those by non-utility subsidiaries, and those by utility subsidiaries approved by jurisdictional state commissions. Removing the Commission's prior review of these financings would improve the ability of such subsidiaries to compete for capital in the marketplace.

The Commission suggests the following modifications to the bill in order to clarify the Commission's responsibilities. Under S. 1174, holding company financings would continue to be subject to Commission review and disapproval if they pose "an unreasonable economic risk to investors or consumers, giving due consideration to the financial practices of public-utility companies and holding-company systems which are not subject to regulation under Sections 6, 7, and 12."

The Commission believes the "unreasonable economic risk to investors or consumers" standard should be revised to reflect the significant changes in regulations and the securities markets since enactment of the 1935 Act. The concepts of disclosure and financial reporting under the Securities Act of 1933 and the Securities Exchange Act of 1934 are highly sophisticated. There is a general consensus that the provisions of the securities laws provide significant investor protection. The Commission sees no continuing basis for believing that investors in these 12 companies require more protection than investors in the other 9,000 publicly-held corporations. Given full disclosure, what constitutes an "unreasonable economic risk" should be decided by investors, as in the case of all other investments.

With respect to "unreasonable economic risk . . . to consumers," some state utility commissions are concerned that they cannot regulate directly financings by interstate systems. The Commission believes these concerns could be met by a provision authorizing the Commission to disapprove non-exempt issues or financing plans, only if the relevant state objects and shows that the holding company financing would have a material detrimental impact on the consumers served by its public utility subsidiary in that state. In making such a determination, the Commission should be required to give due consideration to the ability of a state commission to prevent such a detrimental impact through its authority to regulate the public utility subsidiaries under its jurisdiction.

S. 1174 provides that non-exempt financings will become effective on the 20th day after filing, unless the Commission enters a preliminary disapproval order. If no state requests an extension, the Commission can obtain additional time to consider whether disapproval is appropriate only by issuing a preliminary disapproval order. Such an order could prejudice public opinion concerning the financing. Adherence to such a time limit would require additional Commission staff.

Accordingly, the Commission recommends that issues or financing plans become effective on the 20th day after filing and notice, unless a jurisdictional state commmission objects on the grounds previously stated. Following such objection, the Commission would promptly grant the state commission an opportunity to be heard and make a determination whether to disapprove the issue or financing plan within 30 days after such hearing.

2. Acquisitions and Diversification

S. 1174 would permit registered systems to make non-utility investments up to ten percent of their assets, without Commission approval.

The 12 companies would also be allowed to make non-utility investments beyond the ten percent ceiling, without prior Commission approval of each individual acquisition, pursuant to approved 24-month diversification plans. Under S. 1174, once a diversification plan is approved by the Commission, a registered system would be allowed to proceed with acquisitions under that plan over a two-year period.

This proposal would provide for the effectiveness of both individual diversifying acquisitions and diversification plans on the 60th day after filing of the application, unless the Commission issues an order finding that the investment or plan is likely to "result in unnecessary and unreasonable increase in costs to consumers" or would "impair the performance of any associate company which is a public-utility company of its public-utility service in a manner which is inconsistent with the service obligations of such company under applicable State law."

The Commission believes that reduction of the controls on acquisitions and diversification is in the national interest. As indicated earlier, the circumstances which gave rise to the need for strict controls on diversification no longer exist. The industry is subject to market forces and financial disclosure requirements that impose economic discipline on diversification efforts. Thus, the Commission supports changing the standards regarding acquisitions.

However, S. 1174 would actually increase the costs of administering the 1935 Act, and require additional Commission staff, for two reasons. First, the Commission would have to review acquisitions that presently are prohibited. Second, the 60-day effectiveness provision imposes an absolute time constraint, with no provision for unusually difficult cases or situations where several applications are filed simultaneously.

In order to disapprove an individual investment or a diversification plan, S. 1174 would require the Commission to issue a disapproval order. Under Section 20(c) of the 1935 Act, which S. 1174 leaves unchanged, no such order can issue without notice and opportunity for a hearing. If not satisfied with the information supplied by the holding company, the Commission may request more information, and may order a hearing to take testimony. This process is followed by the task of writing a decision and order. Accomplishing such activities within 60 days would be extremely difficult.

If the Commission should not decide within that time, the plan would become effective.

The Commission believes that these problems can be alleviated. It proposes that authority to prohibit acquisitions be limited to circumstances in which the states cannot adequately protect the interests of their consumers.

Accordingly, the Commission's authority to disapprove acquisitions should be limited to cases in which an interested party or a state commission objects and shows that the investment or diversification plan would have a material detrimental impact on the customers of a public utility within its jurisdiction. In making this determination, the Commission should be required to give due consideration to the state commission's authority to prevent such a detrimental impact through rate or other regulations. A state would be entitled to be heard as a matter of right. Interested parties would be granted a hearing if the Commission determined that their objections were relevant to determining whether the acquisition would have a detrimental impact on public utility consumers. Where the acquisition raises questions of state law, those issues should be resolved in the state courts, not before a federal Commission.

To address these problems, S. 1174 should be amended to require interested parties and state commissions to file objections within 60 days of the filing of a non-exempt diversifying investment or a diversification plan. If a state commission objects, or an interested party raises relevant concerns, the Commission should determine whether to grant a hearing. The Commission should be required to hold such a hearing within 45 days of the expiration of the pre-effective period and to make a determination within 45 days after the hearing.

3. Exemptions from the 1935 Act.

Changes in the industry since the adoption of the 1935 Act render unnecessary the Commission's authority to deny exemptions to companies that otherwise fall within the six enumerated exemption categories. Denial of an exemption where the statutory standards are met should be limited to circumstances where state commissions cannot adequately protect the interests of their consumers. Accordingly, the Commission suggests that the "unless and except clause" in S. 1174 be modified to allow Commission disapproval only in instances where a jurisdictional state commission objects and demonstrates by clear and convincing evidence that the exemption would have a material adverse effect on the public-utility business of the holding company.

4. Additional Controls on Financing.

The Commission recommends deleting or clarifying the clause in Section 6(b)(2) of S. 1174 and other sections, which would require the Commission to give due consideration to "the financial practices of public-utility companies and holding-company systems which are not subject to [the financing restrictions of the Act]" when making a determination whether to disapprove a financing. This clause could be construed to disallow innovative financings that serve one of the 12 companies' needs, merely because they are not in present use by exempt public utilities or other holding companies.

The Commission also believes that it is unnecessary and undesirable for the Commission to have authority to prohibit financings in contravention of state law (as provided in section 7(c) and other provisions of S. 1174), since the states have the ability to do so. Matters of state law should be determined by the concerned state and its judicial system. The Commission does not have the competence to interpret state law and should not be put in the position of having to do so.

5. Affiliate Transactions.

Under S. 1174 the Commission would have authority to adopt rules prohibiting or limiting upstream loans by public utility subsidiaries to their parent holding companies. Since such subsidiaries are subject to pervasive regulation by state utility commissions, such authority by the SEC is duplicative and unnecessary. Furthermore, the Commission notes that, as proposed, S. 1174 would increase the administrative burdens on the Commission and require additional Commission staffing by giving the Commission review responsibility for various transactions that are prohibited under the present Act.

The Commission's authority, as provided in S. 1174, to prohibit registered holding companies from selling public utility company securities, is contrary to the objective of simplifying or eliminating multi-tiered public utility holding companies and should be withdrawn. FERC and the state commissions would continue to have authority to regulate such utilities.

The Commission believes its authority to prohibit intra-system transactions should be limited to instances in which a state objects and shows that the transaction would be materially detrimental to the public utility company's consumers.

Conclusion

The Commission believes the regulatory restrictions imposed by the 1935 Act on public utility holding companies are no longer in the public interest or necessary for the protection of investors and consumers. S. 1174 would reduce these unnecessary regulatory restrictions and increase the ability of the 12 companies to compete in the public marketplace for capital and acquisitions. It is, therefore, a step in the right direction. The Commission believes, however, that the bill needs to be modified to clarify and facilitate the Commission's responsibilities, and urges Congress to give serious consideration to the amendments proposed herein.

Senator D'AMATO. Mr. Chairman, let me focus on two aspects, and then I will submit some written questions to you and to the Commission and I would appreciate your prompt responses so we can utilize that information.

IMPACT OF 10 PERCENT NO-HARM DIVERSIFICATION LEVEL

At yesterday's hearing Commissioner Schuler from the Public Service Commission of the State of New York stated that the no-harm diversification level of 10 percent in this bill, 10 percent of the assets, might be too high. He then suggested that 5 percent of capitalization, might be adequate.

Would you comment on that?

Mr. SHAD. Well, there is an enormous difference, of course, between 10 percent of assets and 5 percent of capitalization.

Senator D'AMATO. Exactly. It is an enormous difference especially because this is referred to as the no-harm level of diversification. Since some corporations have assets that run into billions of dollars. I don't believe a business failure in their diversification plans would adversely impact the utility or the ratepayers, et cetera, as much as a business failure where the corporation is diversified at the 10 percent level. Therefore the question is whether 5 percent of capitalization would be so modest as to defeat the effectiveness of the act?

Would you comment on that? What do you think?

Mr. SHAD. Well, I do agree that 10 percent of assets in the case of a major system is a big number.

Senator D'AMATO. Too much?

Mr. SHAD. I don't really feel it is too much. The reason is that the Commission—this was our unanimous recommendation a year ago—concluded the act ought to be repealed. So while there is no question that there is risk in acquisitions and diversification, there are also benefits.

I really believe the professional managements and their advisers are better qualified to deal with these issues than people who have never bought a company in their lives, never managed a business in their lives. It is really putting a heavy burden on the people that are excellent in other things, but they are not management consulants, not corporate managers. I really think that the rest of the system in the United States works very well, and would tend to support it rather than imposing these kind of detailed regulations on 12 companies. It just seems to be a heavy burden.

Yes, you could say about 10 percent is a huge number, but if our Commissioners at the SEC are unanimous in the view the act ought to be repealed, then it is hard to argue you can have a big enough number.

I think the managements would be very conservative in the administration of these programs. I don't think they will go crazy or do irresponsible things. I think they will do essentially what they are now permitted to do, which is functionally related acquisitions.

Senator D'AMATO. Would it be prudent for Congress in an initial step to set a limitation for the first 2 or 3 years, to see how it does work out?

Mr. **Shad**. That is an interesting approach. The proposals that are on the table are rather dramatic in terms of the removal of the limitations they are now subject to.

Senator D'**Amato**. Would you think about that and maybe respond in further detail for the record?

Mr. **Shad**. Right. Concerning a phase-in, with diversification tied to a percentage of assets? This would be for their nonutility acquisitions?

Senator D'**Amato**. Correct.

[Responses to written questions of Senator D'Amato follow:]

MEMORANDUM

July 12, 1983

To: Chairman John S.R. Shad

FROM: Office of the General Counsel DGoelzer

Re: Response to Questions Submitted by United States Senate Committee on Banking, Housing, and Urban Affairs concerning S. 1174, a proposal to amend the Public Utility Holding Company Act of 1934.

Senator D'Amato, Chairman of the Subcomittee on Securities, has submitted to the Commission several questions regarding S. 1174. The staff has reviewed these questions and has prepared the following analysis.

Question 1: Do state public utility commissioners have the ability and manpower to make determinations as to whether proposed financings and/or diversifications present "an unreasonable economic risk" to consumers?

The Commission has allocated approximately 17 staff years to administration of the Public Utility Holding Company Act. Each of the 50 states has persons assigned to utility regulation, and, in some instances, those persons already review aspects of transactions that must be considered. We believe that, in light of their existing responsibilities, these state officials are in a better possition than is the Commission to make judgments concerning the impact of particular transactions on consumers within that state. State commissions have, of course, broad responsibilities, including pervasive authority over public utility rates, finances, operations, and accounting standards and formats. State commissions are in close contact with jurisdictional utility companies and are intimately familiar with the needs and resources of jurisdictional utility companies and consumers. In general, state commissions have as primary responsibilities the protection of consumer interests and the efficient operation of utilities. As such, state commissions are better able than the Commission to pass judgment on whether financings and acquisitions would have an adverse impact on consumers within their jurisdiction.

Staff resources of state commissions vary, and it is not possible to anticipate in advance what additional burdens the proposed amendments would place on particular state commissions. The states are, moreover, empowered to provide state commissions with additional resources, if needed. Thus, it appears that state commissions have the expertise and have or can obtain adequate staff to determine whether proposed financings or diversifications by utilities present "an unreasonable economic risk to consumers".

Question 2: What is your reaction to my proposal that we phase in the "no harm" level of diversification?

As proposed, S. 1174 would permit registered systems to make non-utility investments up to ten percent of their assets without Commission approval. The Commission has taken the position that the circumstances which gave rise to the need for strict controls on diversification no longer exist; therefore, the Commission has expressed its support for the removal of restrictions on diversifying acquisitions by registered systems. In addition, there is no reason to believe that the management of registered systems will not act responsibly in administering diversification programs. Market forces and disclosure requirements also will impose economic discipline on diversification efforts.

The Commission also has taken the position that the reduction of controls on acquisitions and diversification is in the interest of both investors and consumers. While no investment is risk-free, allowing registered systems to make diversifying investments will create an opportunity for investors to benefit from investments presently prohibited by the 1935 Act. In addition, S. 1174 provides a check on investments by requiring divestiture of any investment that materially adversely affects the operations of the public utility business within the system.

Some have expressed concerns that registered systems, if allowed to diversify freely, may advance too quickly into areas beyond their present expertise. To the extent that this is a real risk, the proposal to phase in a "no harm" level of permissible diversification is a sensible means of addressing it. A "phase in" period should allow registered systems the opportunity to experiment with diversification on an initially limited basis, while permitting Congress and the interested regulatory agencies to evaluate the results. It offers a reasonable and useful compromise to immediate, full deregulation.

Question 3: Who should be charged with the responsibility of policing utility subsidiaries in order to eliminate unfair competitive practices, the Federal Trade Commission, the Justice Department, the Small Business Administration or the Securities and Exchange Commission? Please evaluate the strengths and weaknesses of charging each one of these agencies with enforcement powers.

Neither the Securities and Exchange Commission nor the Small Business Administration is charged with administering the federal anti-trust laws and neither agency has the expertise to do so. */ Those laws are currently enforced

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*/ The Commission does have broad responsibilities concerning a variety of anticompetitive practices in the

(footnote continued)

by the Federal Trade Commission and Department of Justice. The Federal Trade Commission has as one of its principal purposes the responsibility of preventing persons, partnerships or corporations from using unfair methods of competition. Under the Sherman Act, the Department of Justice is responsible for preventing illegal restraints of trade. Both of these agencies have programs in place to police unfair competitive practices and enforce the federal anti-trust laws. Accordingly, it may be appropriate to charge either the Federal Trade Commission or Department of Justice with the responsibility of policing utility activities in order to eliminate such practices. While it may be desirable to consider special statutory provisions to address the problems that would arise from allowing public utility holding companies to diversify, a preliminary analysis suggests that the existing anti-trust laws provide a basis for taking action against utilities that engage in unfair competitive practices.

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*/ securities industry. See, e.g., Sections 6(b)(8), 6(e), 11A(a)(1)(C)(ii), 11A(c)(4)(A), and 23(a)(2) of the Securities Exchange Act of 1934. This expertise would not, however, appear to lend itself to policing competition between utility subsidiaries and other businesses.

Question 4: Should utilities have more or less protection from being the target of a takeover?

Changes in corporate control can be advantageous to both investors and consumers. The threat of a potential take-over tends to provide a check on inefficient and ineffective management. In practice, without this check management can be self-perpetuating. Accordingly, as a general matter, the Commission has taken the position that the federal securities laws should be neutral and neither inhibit nor facilitate tender offers.

However, some believe the unique nature of public utilities as natural monopolies may warrant more protection from takeovers. States also have a strong interest in controlling the ownership of public utilities; that interest arguably would be facilitated by the proposed anti-takeover provision of S. 1174, Section 9(a)(3). In addition, it appears that the proposed anti-takeover provision was helpful in achieving the industry consensus represented by S. 1174. While this provision is generally contrary to the Commission's philosophy stated above, it is an acceptable compromise to achieve the primary objective of removing unnecessary regulatory controls on public utility holding companies.

CK/IV

Senator D'AMATO. Our final witness today will be John Barr, a principal at Morgan Stanley & Co. He is heavily involved with financing and advisory activities in the public utilities industry. In his statement Mr. Barr suggested that the financial flexibility of the registered holding companies is limited greatly as a result of the SEC requirement that the holding companies sell their securities through competitive bidding.

Would you comment on that?

Mr. SHAD. Yes. I haven't seen any current studies. I have seen some older studies that indicated that gross spreads in competitive biddings were a shade lower than they were on negotiated transactions.

The other side of the coin is that the investment bankers render a variety of assistance when they have a negotiated relationship, in terms of both the structuring and the timing of financings, which could offset any benefit on the gross spread many times over.

So I think that they ought to have an option. I think these holding companies ought to have the same options as all other companies. If they believe it is to their advantage, they would solicit competitive bids. If they believe it is to their advantage to do negotiated offerings, they ought to be at liberty to do so.

Senator D'AMATO. Is there any additional risk associated with competitive bidding?

Mr. SHAD. Any additional risk to the issuer—I am not sure of your point.

Senator D'AMATO. Let me ask you this: If you are forced to bid competively instead of negotiating transactions don't you risk that market fluctuations will force you to pay a higher interest rate?

Mr. SHAD. Yes, it could. The markets are much more volatile than they used to be. You have to solicit competitive bids in advance. That is a good point.

Senator D'AMATO. As a corporate manager, wouldn't you like the flexibility of being able to go either way?

Mr. SHAD. Yes, exactly. I think it would be in the consumers' and investors' interest to permit them to do so.

Senator D'AMATO. During yesterday's hearings one of the persistent problems that came up and was testified to by Congressman Corcoran among others—was the cross-subsidization by the utilities of some of their activities, particularly plumbing, heating and so forth. Also, there was a fear that if diversification was to be allowed these problems would occur more frequently.

Of course you have heard my statement that the problem exists now and that this act is not responsible for it, but there are those who have come forward saying this as it is an easy thing to beat up on utility companies. Back home on Long Island the most hated object is the utility company. The ratepayers face a 56-percent rate hike over the next 3 years, so it is easy to understand why the public becomes so enraged.

But in light of your statement that the 12 holding companies are overregulated, would you recommend that the FTC, SBA, or Justice Department be charged with the responsibility of policing utilities' subsidiaries, in order to eliminate these alleged unfair competitive practices? That is, the cross-subsidization.

Mr. **Shad**. Yes. I can say that I do not think the SEC should be charged with that responsibility. It would be foreign to our other areas of responsibility. We are basically a disclosure agency, and an enforcer of securities laws, not unfair competition laws.

Senator D'**Amato**. How about the FTC?

Mr. **Shad**. It would seem to me that would be the logical place for it.

Senator D'**Amato**. Let me ask you if you wouldn't again look at that particular area and comment as to how we could deal most effectively with the problem of cross-subsidization and who should be the enforcing agency, and what legislation, if any, there should be? That is a heavy task, but I would appreciate your comments in regard to this important area.

ANTICONGLOMERATE FEATURES OF S. 1174

Mr. Shad, your statement is silent on an important section of S. 1174 which would extend the anticonglomerate features of the act by requiring SEC approval before a company could acquire 5 percent or more of a single public utility.

Do you support the elimination of the free first bite as proposed in section 9(a)3 of the act?

Mr. **Shad**. I would like to say that I highly commend you and this committee for bringing about the consensus of the industry that you have from where they were a year ago—with three separate bills, each in their own narrow interest.

This is a major improvement. I certainly have a reaction to that proposal, because I think there are some advantages in changes of corporate control. There are disadvantages as well; it is not black and white.

Right now the SEC has an Advisory Committee on Tender Offers that is looking at this whole area. We will be receiving their final report in July. Their recommendations involve changes in corporate control. It does have some disciplinary effects on management.

I think the concern of so many in the past has been the total absence of accountability of professional management. They are often self-perpetuated, they control the nominating, the proxy machinery, and it becomes a fairly routine function to reelect them.

I am not sure—would the Commission oppose it? Those of us who participated in this discussion concluded that it probably was needed to bring about the consensus that you have achieved among the industry. There are many very desirable features of S.1174, so we didn't interpose an objection to elimination of the first bite.

Senator D'**Amato**. With regard to utilities the question comes up as to whether or not, in the public interest they should receive some additional protection from the so-called raiding corporations given the fact that they are monopolies? I am not going to ask you to comment in detail at this time, but I would like a written response if possible to that, unless you care to comment now.

Mr. **Shad**. No, I will be glad to provide a written response.

Senator D'**Amato**. I would appreciate that. I think it is important that the record reflect the Commission's attitude in regard to this policy matter as to whether or not the utilities should have a little more protection in this area.

Senator Sarbanes.

FINANCING BY INTERSTATE SYSTEMS

Senator **Sarbanes**. Thank you, Mr. Chairman. Chairman Shad, on pages 7 and 8 of your testimony you state "some State utility commissions are concerned that they cannot regulate directly financings by interstate systems."

I take it your view is that the Commission at the Federal level should in effect recede from this area entirely. Is that correct?

Mr. **Shad**. Yes.

Senator **Sarbanes**. That of course then raises the question——

Mr. **Shad**. I would add a "but" to that "yes." Yes, but we propose to try to facilitate the State commissions opportunity to intercede directly. We appreciate the problem they are raising concerning their limitations, so in our formal testimony we do propose a manner in which to afford them a full opportunity to prove that nonexempt financings would be detrimental to their ratepayers.

Senator **Sarbanes**. So, in other words, you accept the assertion of the State utility commissions that there is a problem, since they are State institutions, with respect to interstate systems? Would that be correct?

Mr. **Shad**. Well, yes, with some qualification that is true.

Senator **Sarbanes**. Again it is your view that this concern, as you state here, can be met by a provision authorizing the SEC to disapprove nonexempt issues on financing plans, if the State objects and makes a showing of material detrimental impact? Is that right?

Mr. **Shad**. That is correct.

Senator **Sarbanes**. Why should the State have to do both of those?

Mr. **Shad**. Because we are greatly removed from the issues and the problems of the utility consumers. They are on the scene and that is their primary responsibility, to protect consumers, so they are much better than we would be in a position to make the case.

Senator **Sarbanes**. If that is the case, why shouldn't the objection, the bonafide objection of a legitimate State agency be sufficient without accompanying it with a showing?

Mr. **Shad**. I think the concern is overstifling. I think the fundamental argument is that these regulations place the corporations at a competitive disadvantage with virtually all other corporations in affecting acquistions and financing.

And that is detrimental in the view of many, to both the shareholders and the consumers. So you need a balance, and I would say that they should only be blocked from doing what all other American corporations are permitted to do, including all the other utility holding companies, and the telephone, the sewage and the water and all these other industries. They are permitted to compete. They have these arguments that these companies do not or that they can't be barred from pursuing. So for that reason I think there ought to be some burden justifying exposing these kind of restrictions on these companies, and that would be by demonstrating that whatever would have a material effect on consumers.

Senator **Sarbanes**. If the State commissions makes the judgment, why shouldn't that be adequate for the Commission then to consider making this finding, without the additional requirements imposed on the State commission?

Do you assume the State commissions would act unresponsibly or unreasonably?

Mr. **Shad**. I think their focus is on the interests of consumers within their State. The question is should they be permitted to inhibit the whole system. In many instances the majority of the stock of the parent holding company is owned throughout the country, not just by the individuals within that State.

Is it fair to let the existence of a one-percent interest in a utility company veto such action?

Senator **Sarbanes**. Who is going to be looking after these consumers?

Mr. **Shad**. The State commissions, by demonstrating—pardon me?

Senator **Sarbanes**. In those instances in which you have a regulated monopoly, who is going to be looking after the consumers?

Mr. **Shad**. The State commissions.

Senator **Sarbanes**. Well, but you're placing a very heavy burden on them.

Mr. **Shad**. Only to demonstrate that if the plan is approved as proposed it would have a material adverse effect on the consumers within their jurisdiction. I think that's the least they should be asked to do.

Senator **Sarbanes**. What does the standard of material detrimental impact encompass?

Mr. **Shad**. Well, it's terminology that the SEC is used to dealing with in the sense of being material. That would mean not insignificant, and in some way jeopardizing or having a harmful effect upon the consumers or the operating subsidiary itself which therefore would have an adverse effect on consumers.

Senator **Sarbanes**. How heavy a burden would that be on the State public utility commission?

Mr. **Shad**. Pardon?

Senator **Sarbanes**. How heavy a burden is that?

Mr. **Shad**. Well, the standard of proof suggested is clear and convincing evidence. If you approach the issue from where the SEC has unanimously been, as a Commission, that the bill ought to be repealed, then, this is a reasonable compromise. It's something in between.

The reason is that it's the view of the Commission that these State utility commissions have pervasive authority over the operating companies and now we are trying to go out of State to the holding company levels and give them power at that level as well. This I think is a reasonable compromise.

Senator **Sarbanes**. What do you think the impact of all of this will be on local control of public utilities? Do you anticipate a movement away from local control of public utilities?

Mr. **Shad**. I can't predict with any confidence what the effect would be. I think you could have it go both ways.

Another recommendation in our formal statement is that the limitations on holding companies' ability to sell the interest in their local operating utilities be eliminated because the intention of the act was to reduce holding companies structures. If they want to dispose of their equity in it—I think there could be some dispositions either through public offerings or the sale to others. Again, who the buyers are would be totally in the control of the State utility commissions. They could approve or disapprove the transaction.

OUTSIDE GROUPS SEEKING PUBLIC UTILITIES

Senator **Sarbanes**. Most of the discussion has been in terms of the utilities diversifying their activities. What about outside groups coming in and seeking to pick up the utilities, to provide themselves with an economic base for broader activities? Does that cause you any concern, and how much of that do you anticipate?

Mr. **Shad**. Well, I wouldn't anticipate much because of the regulated nature of the industry and because of the proposals in S. 1174 that continue the 1935 act limitations on changes of control, and even more restrictive provisions included in S. 1174. So, I wouldn't think that there would be much change of control of these utilities.

Senator **Sarbanes**. We had testimony yesterday suggesting that further protections were needed against that possibility. Are you familiar with that testimony?

Mr. **Shad**. Chairman D'Amato referred to it.

Senator **Sarbanes**. What's your view?

Mr. **Shad**. The first bite question of up to 5 percent? Perhaps you could state it for me. I'm not sure I'm fully familiar with it.

Senator **Sarbanes**. Mr. Jackson testified before us. I commend his testimony to you, and then ask you to let us know your view on the proposals contained in his testimony with respect to this question of outside acquisitions. I think it would be helpful to have your view on that.

Mr. **Shad**. I'd be pleased to.

Senator **Sarbanes**. Did I understand that in response to the chairman you were suggesting that the FTC be introduced into this arena on the anticompetitive practices question?

Mr. **Shad**. Well, I gave a definite reaction that the SEC is not the suitable depository of that responsibility. The FTC is charged with administration of certain antitrust laws and has certain consumer protection responsibilities, but I think Jim Miller would be a better person to ask about whether that would be the best place. I don't know. Justice also, of course, should be considered on the antitrust question.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Senator **D'Amato**. I'd ask you again to direct particular care to that question on the anticompetitive aspects, have your people research it. I also think that maybe we should get in touch with the FTC and ask them for their thoughts. I mention that to the committee in regard to this. I don't know whether it would take another hearing, but I'd certainly at the staff level like to see that we pursue that and, Chairman Shad, you might undertake some contacts with respect to that because I think that avenue has to be covered. I think it's important. It's a problem that exists now. I don't think S. 1174 would exacerbate it, but I think sometimes we deal with the perceptions in how people see these things and there's no sense in derailing legislation that I think could be helpful to our economy and to this industry simply because we didn't take the adequate steps necessary to deal with this present problem.

Thank you very much, Mr. Shad.

Mr. SHAD. Thank you, Mr. Chairman and Senator Sarbanes.

Senator D'AMATO. Alan H. Richardson, legislative director and counsel, American Public Power Association.

STATEMENT OF ALAN H. RICHARDSON, LEGISLATIVE DIRECTOR AND COUNSEL, AMERICAN PUBLIC POWER ASSOCIATION

Mr. RICHARDSON. Mr. Chairman and members of the subcommittee, you have my prepared statement and I would like to summarize.

Senator D'AMATO. Your testimony will be received in the record in its entirety.

Mr. RICHARDSON. Thank you very much. I have here a copy of a statement submitted by the Great Lakes Electric Consumers Association that is a regional organization of public power and rural electric cooperative systems. They have some comments to offer on S. 1174 and I would like to submit those for the record.

Senator D'AMATO. We will receive those into the record.

Mr. RICHARDSON. My name is Alan Richardson and I am the legislative director and legislative counsel for the American Public Power Association. APPA is the national service organization representing over 1,750 local public power systems throughout the United States. We appreciate this opportunity to testify today and discuss S. 1174, the Public Utility Holding Company Act Amendments of 1983.

Over 900 local public power systems purchase all or a portion of their power wholesale for subsequent distribution to their retail customers. We are therefore legitimately concerned with any changes, including those relating to diversification, which alter the regulatory framework and which may create a potential to increase our costs and our costs to our consumer owners.

I'm extremely pleased that the focus of the hearings this year have shifted away from repeal of the Holding Company Act to consideration of possible amendments. While some may still favor repeal, many, including Chairman D'Amato, have concluded that preservation of the act is in the public interest and we wholeheartedly agree.

ACT VIRTUALLY UNCHANGED FOR 50 YEARS

The act has survived, however, virtually unchanged for over 50 years and perhaps does need to be fine tuned. Our concern is that in tampering with this very complex act we may, through design or inadvertence, so drastically alter the effective regulatory scheme as to be the appearance of SEC jurisdiction without any possibility that such jurisdiction can be exercised effectively. We are not dealing with ordinary business enterprises. We are dealing with public utilities providing essential services under monopoly conditions. For that reason, I hope you will heed the advice offered by Dr.

Schuler of the New York State Public Service Commission yesterday to proceed with great caution.

Many others have expressed the same view, including the executive director of the Maryland Public Service Commission in a letter to Congressman Tom Corcoran in November 1981.

I hope you will consider as well some comments on, and advice regarding diversification in the nonutility area contained in a book "In Search of Excellence, Lessons From America's Best-Run Companies." Chapter 10 of that book is entitled "Stick to the Knitting," and deals with corporate mergers and diversification. The authors point to what they see as the increasingly familiar story in today's business environment and I will quote for a moment:

> The company decides it is in a sluggish business. It determines to move afield. It doesn't know what it's buying. It buys companies at or past their peak. Moreover, it doesn't understand them. Finally, and most devastating of all, the effort and attention going into the management of the new acquisitions sap the vitality of the already shake core business.

The authors don't suggest that there should be no diversification, although they note in their opinion that there is "an almost total absence of any rigorous support for very diversified business combinations." They do urge that companies stick close to their knitting and this fact is based on a principal finding that organizations that do branch out but stick very close to their knitting outperform the others.

Utilities which have diversified generally have stuck close to their knitting, due in part, of course, to restraints, either active or passive, which are currently imposed by the act. The utility witnesses yesterday said that they would pursue the same philosophy in the future no matter what happens to the act and I think certainly most will, but there is a possibility and indeed the probability that some won't. Therefore, not only is it essential that caution be exercised in dealing with the questions of amendments to the act but the amendments themselves must be cautiously and conservatively drafted to insure that the public, the investors, and the consumers are protected.

PROPOSED AMENDMENTS TOO LIBERAL

For this reason, we believe the amendments proposed in S. 1174 are far too liberal. What the act currently prohibits, unless specifically authorized by the SEC, the bill would essentially permit unless specifically disallowed. Whereas the act provides exemptions, on the presumption of the existence of effective State regulation, the bill provides for exemptions virtually guaranteed to result in the formation of holding companies whose nonutility activities would be totally beyond the reach of State commissions. Whereas the act is premised on preventing or correcting activities detrimental to the public interest and to provide protection for investors and consumers, the bill contains new standards such as the prevention of unnecessary and unreasonable economic risks for consumers, and at the same time, denies the commission the opportunity to examine whether proposed activities might be detrimental to the public interest.

With this as a backdrop, I would like to offer some suggestions regarding how we might most profitably structure the debate which will undoubtedly follow these hearings.

First, we are past the point of debating the merits or demerits of utility diversification. Diversification is a fact. It's unrealistic to suggest that utilities should be confined solely to the generation, transmission, and distribution of electric energy. Indeed APPA is encouraging its own member systems to look beyond those traditional functions.

Second, proceeding from that point, we are presented with at least two major conflicts. The first is the fear expressed by contractors who testified yesterday that utilities will move into areas of their expertise and overwhelm them because of their size, financial, and customer-access advantages. This is in direct conflict with the suggestion that utilities should stick close to their knitting.

The second major conflict is the utilities' desire to diversify in the holding company structure and the problems that that poses for effective regulation. The holding company structure may be the best way to separate utility and nonutility activities; at the same time, it creates regulatory problems. In fact, some State commissions have suggested that the real reason for diversifying through the holding company structure is simply to avoid regulation.

Third, the debate should focus on a limited number of critical issues, specifically what activities prohibited in the past should now be submitted and to what extent, and if activities previously prohibited are to be allowed should they be allowed individually or subject to some review. If changes are to be made in the area of increasing the number of utilities entitled to exemptions, to what extent will these changes diminish effective State regulation over the holding company and the utility operations, and how will these voids created be filled? Third, to what extent will the SEC retain jurisdiction to condition exemption applications, grant exemptions, and withdraw exemptions once granted?

Finally, and most importantly, what standards should be applied and who will bear the burden of proof?

I can't offer definitive answers to these questions. I have some comments on them in my prepared testimony. I would offer a few comments on some of these questions.

First and in order, some additional latitude may be appropriate for registered companies to diversify, but, as urged yesterday by the NARUC witnesses, within more closely defined limits than contained in S. 1174 and subject to effective commission regulation.

Second, the new exemption language adding section 3(a)(6) has the potential of frustrating State commission regulation. S. 1174 proposes to fill the void by providing a mechanism for access to holding company books and records. The NARUC witnesses offered some comments on the problems that would be encountered with using that mechanism and suggested that significantly more work needs to be done in this area.

Third, under S. 1174, the SEC would not have the authority to condition exemptions, would be required to grant exemptions as a practical matter since their authority could not be used effectively with respect to the granting of exemptions. And finally, while the authority to withdraw exemptions would be retained, the test is exceedingly difficult to meet.

Fourth, and what I regard as the final and most difficult question, the standards to be applied and the burden of proof. We believe that the burden should be borne by the party proposing the activity. An applicant for an exemption should demonstrate an entitlement, while an action to repeal an exemption should place the burden squarely on the SEC.

As to the standards, why deprive the commission, for example, of an opportunity to examine whether a proposal is detrimental to the public interest as is the case of so many standards suggested in S. 1174? Application of the public interest standard may be somewhat nebulous but its virtue is its flexibility. It allows for adaptation to a constantly changing environment. It also provides perhaps some resolution of the two conflicts I pointed out previously; that is, the contractors' concern versus the desirability of sticking close to the knitting, and the conflict between the advantages of the holding company structure and effective regulation. These are issues which are essentially public interest considerations and questions.

Mr. Chairman, that concludes my remarks. I have not attempted to address many of the issues contained in my statement. I do support in my statement provisions regarding section 9(a)(3) and, of course, the continuation of the Holding Company Act and protections it provides with respect to acquisition of utility property. I would be happy now to respond to any questions you might have.

[Complete prepared statement and statement of Great Lakes Electric Consumers Association follow:]

Statement of
Alan H. Richardson, Legislative Director and Counsel
AMERICAN PUBLIC POWER ASSOCIATION

on the

Public Utility Holding Company Act of 1935
Presented to the
Subcommittee on Securities
Senate Committee on Banking, Housing and Urban Affairs

June 15, 1983

Mr. Chairman, members of the Subcommittee, my name is Alan H. Richardson. I am the Legislative Director and Legislative Counsel for the American Public Power Association. APPA is the national service organization representing over 1,750 local public power systems in 48 states, Puerto Rico, Guam, American Samoa, and the Virgin Islands. I am pleased to have the opportunity to testify before you today on S.1174, the Public Utility Holding Company Act Amendments of 1983.

APPA is interested in both the continuation and the effective administration of the Public Utility Holding Company Act by the Securities and Exchange Commission for two reasons. First, the Act was passed to prevent, and where appropriate, remedy situations found detrimental to the public interest and to protect the interest of investors and consumers. Public power systems are large consumers. More than 900 local public power systems thoughout the country purchase some or all of their power from investor owned utilities. These systems and their customers have enjoyed the protections afforded by this Act for nearly 50 years. Removal of the regulatory constraints imposed by Congress on electric utility holding companies could adversly affect these public power systems.

Second, the antiturst/anti-takeover aspects of the Act have been used effectively by publicly owned utilities to prevent the concentration of control of the bulk power market in the hands of the few largest utility systems, preserving at the same time their access to wholesale power supply.

Last year this subcommittee had before it several proposals to either amend or repeal the Public Utility Holding Company Act. I was pleased to note, Mr. Chairman, that in your statement introducting this legislation on April 28, 1983, you stated that as a result of the hearings during the 97th Congress you became convinced that repeal of the Act would not be in the public interest.

The bill before you today, however, S.1174, while not repealing the Act, amends it in such significant respects as to approach *de facto* repeal. S.1174 contains many of the major elements of S.1869, S.1870 and S.1871 which were considered by your Subcommittee last year. In commenting on these bills, Securities and Exchange Commission Chairman John S. R. Shad, in a letter to this Subcommittee dated December 21, 1981, stated as follows:

> "The Commission finds it difficult to support any of the three legislative proposals presently before Congress because each primarly addresses only those aspects of the Act which affect one segment of the industry. Each would have the practical effect of virtually repealing the Act as it affects that particular industry segment. Taken together the three proposals approach total repeal and would leave the Commission with the responsiblity for administering only the very limited surviving provisions of the Act with no clear regulatory purpose."

Commissioner Shad, of course, concluded with the recommendation from the SEC that the Act be repealed. This is a proposition you have expressly concluded would not be in the public interest.

Clearly, there are differences between S.1174 and the three bills considered during the 97th Congress. The drafters have made an effort to provide greater Commission authority in some areas. For example, S.1870 would have prohibited the SEC from withdrawing an exemption once granted whereas S.1174 would continue, although under greatly modified circumstances, such authority. Nevertheless, a brief overview of S.1174 demonstrates how drastically the authority of the SEC is reduced or eliminated.

What the Act prohibits, unless specifically authorized by the SEC, the bill would essentially permit, unless specifically disallowed. Whereas the Act provides exemptions premised on the presumption of the existence of effective state regulation, the bill provides for exemptions virtually guaranteed to result in the formation of holding companies whose non-utility activities would be totally beyond the reach of state commissions. Whereas the Act was premised on preventing or correcting activities detrimental to the public interest and to provide protections for investors and consumers, the bill contains new standards such as the prevention of unreasonable economic risks for consumers and at the same time denies the Commission the opportunity to examine whether proposed activities might be detrimental to the publc interest.

While the bill may approach repeal of the Act in some resects, specifically in the areas of diversification and SEC jurisdiction over financings of registered companies, it does preserve some aspects of the Act of particular significance to public power systems. Specifically, jurisdiction of the SEC over acquisition of utility securities and assets is retained and in fact strengthened. Nevertheless, the thrust of the legislation leaves the SEC with little more than the semblance of jurisdiction with little authority to act effectively to protect the public and investors and consumers.

Proponents of amendments or repeal advance two major arguments. First, they argue that the Act is an impediment to utility diversification into other business ventures. The opportunity to engage in diversification programs unrestrained by the Act or the SEC is viewed as at least a partial solution for the financial problems confronting the utility industry. Presumably, through diversification will come better management, stronger financial help, diversification of risk, lower capital costs, and ultimately, lower cost for utility consumers. Second, they suggest that the Act has accomplished its primary purpose. Other regulatory bodies at the state and federal leval and other provisions of law such as the Securities Act of 1933 and 1934 have eliminated the necessity for active regulation pursuant to the provisions of the '35 Act. In short, it is suggested that the Act is redundant, imposes additional regulatory burdens which are costly and unnecessary, and therefore significant modification is warranted.

The Financial Condition of the Utility Industry

Setting aside the merits or problems associated with diversification, it is appropriate to look for a moment at the current financial condition of the utility industry. Attached to my statement is a brief description of how the financial position of the utility industry has improved in the recent past. It is apparent from this that the utility industry today is in quite good financial health.

Even if utilities were suffering from financial distress, it is not clear that diverfication would improve the situation. In late

1981, Congressman Tom Corcoran (R.,IL) asked utility companies and many State Commissions for their opinions on proposed amendments or repeal of the Public Utility Holding Company Act. While most utility respondants favored repeal or amendment of the Act to premit diversification and thereby improve their financial posture, some respondants had other views.

For example, Charles B. Finch, President of the Allegheny Power Systems, Inc. stated that "in our judgement, neither the repeal or amendment of the Public Utility Holding Company Act would affect the financial plight of the utility industry. That plight is a direct result of the failure of state regulatory commissions to price electricity at its true cost.... The point about diversification is that it is not a substitute for bad regulation. It will not help the financial plight of utilities and might well end up adversely affecting the quality of their service."

The Act is not Redundant

Mr. Chairman, you yourself have stated that it would not be in the public interest to repeal the Holding Company Act. Clearly, you have concluded, based on that statement, that the Act is not redundant. Many others have reached the same conclusion.

For example, in responding to the Corcoran inquiry Michael V. Hasten, Chairman, Illinois Commerce Commission, stated "I think it is interesting to note that some are arguing that the PUHCA is superfluous. That argument strikes me as significant in itself to support the Act's effectiveness and the need for its continued existance without significant amendment."

Another respondant to the Corcoran letter, William J. Pruyn, President and Chief Executive Officer of Eastern Gas and Fuel Associates, also addressed this question. He stated "Clearly, none of the disclosure provisions of the other statutes administered by the Securities and Exchange Commission would be a substitute for Sections 6, 7, 9 and 10 of the Public Utility Holding Company Act which regulates sales and purchases with a view to preventing a return of the evils that the geographical integration and corporate simplification provisions of Section 11 of that Act were designed to cure."

The Burdens of Compliance

There are those, of course, who will argue that while the Act is not redundant, compliance is excessively costly and burdensome. Such arguments are advanced only by registered companies since there are as you know, virtually no compliance burdens imposed on exempt holding companies. There are to be sure some burdens and compliance costs imposed on registered companies. Registered companies have stated that compliance costs amount to $500,000 or more per year. For small businesses, this would represent a real burden. However, the registered companies are certainly not small businesses. The nine registered electric utility holding companies, as of December 31, 1982, had total assets in excess of $56 billion with operating revenues of $21 billion.

Against whatever compliance burdens exist this Committee must weigh the benefits which have accrued to investors, consumers and the general public. In contrast to the complicated financial structure of the holding company systems in the '30's, todays holding company systems operate in a straightforward and uncomplicated manner. The uniform, simple, capital structure of the existing holding companies have promoted investor confidence and have helped to hold down the cost of capital. Because of this straightforward and simple capital structure these systems have a higher investment quality and therefore a lower cost of capital. We are not persuaded by the argument that because the systems have a simple capital structure today they will continue to have such a capital structure tomorrow should the the Act be modifided as posposed by S.1174.

In addition to cost, registered companies have argued that repeal would reduce the cost of opportunities which are lost to them due to the Act. These opportunities are lost presumably due to the requirement of prior SEC review of financial offerings. The registered companies would have us believe that the Act requires them to obtain prior SEC approval for each security issuance. This is manifastly not the case. Some time ago, the SEC adopted a policy of encouraging registered companies to pre-file financing programs covering a one year period. Through one order, the financing program can be approved. Utilities are then free to enter the market at the most propitious time.

I find neither the "financial plight curred by diversification" argument nor the "superfluous-redundancy-burdensome" argument persuasive reasons for modification of the Holding Company Act. Perhaps a better explaination of the driving motivation behind this effort is contained in the letter to Congressman Corcoran from Mr.

Pruyn of Eastern Gas and Fuel Associates to which I referred earlier. He stated:

> It also occured to me that there is really nothing in the Holding Company Act to prevent the diversification of electric or gas companies as long as they do not create public utility holding companies. That is to say an electric or gas operating company is free so far as the Holding Company Act is concerned to organize as many non-utility subsidiaries as it likes. The catch is that the state utility commissions might well have something to say in that event. In other words the real impediments to diversification come from state law not federal. Thus, what the proponents of repeal really want it might be argued is to be free of any control whether federal or state so far as diversification is concerned. Whatever the merits of diversification, further thought must be given to the relative safety, particularly in view of the background of abuses that produced the Holding Company Act, of permiting unchecked diversification.

Similar comments were expressed by Mr. Hasten of the Illinois Commerce Commission in his letter to Congressman Corcoran. He stated:

> It appears that the organization of a holding company by a utility for the purpose of diversification through a non-utility subsidiary may be a device to avoid state regulation altogether. This is dangerous and clearly not in the public interest. Proposed amendments to Section 3 of the Act would eliminate federal restraints as well from such a holding company. Since these amendments do not appear to be founded on public interest arguments I cannot support their enactment. Moreover, I would be significantly dismayed to find the United Stated Congress an instrument in this effort to escape state regulation.

Utility Diversification

One of the major reasons for this legislation is to permit utility diversification virtually free from any federal regulatory constraints or oversights. To this end, the legislation would: 1) Encourage or at the very least permit the incorporation of the parent holding company in a state far removed from the location of the public utility subsidiary, thereby increasing the difficulties of state regulatory commissions; 2) Condition the granting of exemptions as well as exemption withdrawal on a test which literally cannot be satisfied until after some material adverse affect has been experienced by the public utility business; 3) Permit registered holding companies to diversify into non-functionaly related areas within certain very generous limits without prior review or approval of the SEC; 4) Permit registered holding companies to diversify beyond those limits upon the filing of specific applications or diversification plans and imposing upon the Commission the burden of demonstrating that the plan or application would harm the utility operation rather than placing the burden on the utility to demonstrate that its plan or application is in fact in the public interest and would promote the interest of investor or comsumers; and 5) Permit registered companies to retain their interest in non-functionally related business ventures unless the Commission can demonstrate that the retention is having a material adverse affect on the public utility business.

Before addressing each of these specific aspects of the legislation, it is beneficial to examine in a general way the benefits and hazards of utility diversification and then look at what the Act presently premits.

The pros and cons of diversification have been extensively addressed in many publications and studies. Diversification has been supported because it would, it is argued, improve the overall financial condition of the holding company and reduce capital costs which would benefit customers. Further the diversification of risk would presumably facilitate public utility financing. Finally, the challenges of running a diversified company would make it easier to attract and retain highly qualified managers. On the opposite side, those who oppose, or urge a "go-slow" approach, point out that diversification ventures may not succeed and capital costs could increase. Managers might devote their attention to the new acquisitions, to the detriment of the primary business of running the utility. Diversification might benefit or harm stockholders but, in the captive customer utility situation, the customer bears the risk of failure without any real participation in the benefits of success.

While diversification has been restrained in the utility area for a number of reasons, including the presence of the Public Utility Holding Company Act, diversification and merger mania has been in vogue in other parts of our society for some time. An examination of the consequences of this fad can shed some light on this debate.

The issue of corporate diversification is discussed in the recently published book In Search of Excellence - Lessons from America's Best Run Companies, by Thomas J. Peters and Robert H. Waterman, Jr. (Harper & Row, publishers, copyright 1982) in chapter 10 entitled "Stick to the Knitting." As one might gather from the chapter's title, the authors suggest that the best approach to diversification is a cautious one in which the company undertakes new tasks which are very closely related to the business they already understand. Some quotes illustrate some of the authors' major conclusions:

> "It is a simple fact that most acquisitions go awry. Not only are the synergies to which so many executives pay lip service seldom realized; more often than not the result is catastrophic. Frequently the executives of the acquired companies leave. In their stead remains only a shell and some devalued capital equipment. More important, acquisitions, even little ones, suck up an inordinate amount of top management's time, time taken away from the main-line business. (p.293)

> Our principal finding is clear and simple. Organizations that do branch out (whether by acquisition or internal diversification) but stick very close to their knitting outperform the others. (p.293)
>
> Least successful, as a general rule, are those companies that diversify into a wide variety of fields. Acquisitions especially, among this group, tend to wither on the vine. (p.293-4)
>
> In one study published in the *Journal of Finance* in 1975, Robert Haugen and Terence Langetieg tested the popular notion that mergers create operating or strategic synergies which are not present when the firms are owned separately. Their criterion for judging whether mergers produced synergies was return to common stockholders. After evaluating the effects on stock price of fifty-nine nonconglomerate mergers that took place between 1951 and 1968, Haugen and Langetieg concluded: 'We detect little evidence of synergism in our sample....Any stockholder could have obtained the same results on his own by combining the shares of the two companies in the appropriate proportions in his portfolio.' (p.295-6)
>
> As it turned out, the only clear effect Haugen and Langetieg were able to confirm was an increase in the variation of stockholder returns in the merged firms. In other words, investing in the two companies that chose to merge their assets under a single capital ownership structure was a *riskier* proposition than investing in a pair of companies that elected to remain in their base businesses. This finding, which other researchers have confirmed, casts doubt on one of the primary arguments for mergers -- diversifying business risk. (emphasis in the original) (p.296)
>
> We are almost apologetic for subjecting the reader to this onslaught of often arcane analysis. But with merger mania as prevalent as it is, it seems worthwhile to illustrate rather exhaustively the almost total absence of any rigorous support for very diversified business combinations." (p.296)

The authors then offer the following general characterization of a failed diversification venture: "The company decides it is in a sluggish business. It determines to move afield. It doesn't know what it is buying. It buys companies at or past their peak. Moreover, it doesn't understand them. Finally, and most devastating of all, the effort and attention going into the management of the new acquisitions sap the vitality of the already shaky core business." (p.304) We fear this scenario could too easily be followed by electric utility holding companies.

It would seem that the drafters of the 1935 Act had in mind for the utility industry precisely the same advise given by Mr. Peters and Mr. Waterman -- "stick to the knitting." The Act was designed to achieve this result, and it has to a large extent been successful.

Exempt holding companies are free to engage in prudent and limited diversification. They do so, of course, always with an eye to the "unless and accept" clause and the possibility that the Commission, exercising its authority under that clause may withdraw the exemption and force registration.

Exempt companies, however, are not sailing in uncharted waters. Some general guidelines to exempt holding company diversification were established by the SEC in the Pacific Lighting Case. The SEC stated that non-utility activities should be segregated from utility activities. Contracts and sales and services between the utility and the subsidiary should not be allowed except to the extent that they were subject to state supervision and regulation. Utility funds and credit and management should not be used for non-utility purposes. Non-utility investments should be restricted to activities complementary to the utility operations or to established business with a successful and stable record of earnings over a period of time. And finally, non-functionally related business acitivies should constitute only a small component of the entire system. In applying this last standard, however, apparently the SEC does not look simply to the extent of diversification but rather to the nature of the diversification and the related financial transactions to determine whether they have put the financial health of the holding company and/or utility subsidiaries in jeopardy.

The Pacific Lighting Case standards were discussed by Jerald L. Jacobs, Senior Vice President-Finance, Atlantic Electric Company in New Jersey in his response to Congressman Corcoran's inquiry. He stated as follows: "In our opinion, the above guidelines largely parallel the requirements which a prudent management team would impose on itself." With respect specifically to modifications of Section 3 of the Act, Atlantic Electric states, "The effect of removing the 'unless and except' clause is to eliminate the basis for the SEC's having to decide when diversification is contrary to the public interest or interest of investors or consumers. The guidelines currently used by the SEC are, as we have seen, rather liberal. Not far removed from the self-imposed requirements of prudent management." Atlantic Electric did note, however, that the interpertation of the Act and the general guidelines could change, presenting diversified utilities with the possibility of forced divestiture of profitable subsidaries.

Diversification by registered companies is more tightly controlled by the SEC. Registered companies are restricted to diversification ventures in areas which are "functionally related" to the utility operation. The Commission must find that these activities are necessary or appropriate in the public interest or for the protection for investors or consumers and will not be detrimental to the proper functioning of the utility system.

There is some logic to this functionally related test. There are economies which might be captured by utilities engaging in functionally related activities. Diversion of managerial attention might be a less serious problem since the new venture is closely related to the operation of the utility itself.

But even with functionally related diversification there are some problems. Functionally related activities are not necessarily low-risk ventures, for example, oil and gas fired utilities can engage in oil and gas exploration activities. Such activities are inherently risky.

Past experience has demonstrated that not all functionally related diversification ventures have operated to the benefit of the utility's customers. A recent study by the Federal Energy Regulatory Commission addressed the issue of utility captive coal mine operations. The study found that captive coal prices were, on average, significantly higher than comparable non-captive coal prices. Captive coal mines appeared to be operating less efficiently than comparable non-captive coal mines. Finally, regulation of electric utility affiliated coal operations may be inadquate to assure the efficient management of captive mines and the reasonableness of the captive coal prices.

Similar conclusions on captive coal operations were reached by the President's Private Sector Survey on Cost Control, Task Force Report on Boards, Commissions - Business released in May, 1983. This task force reviewed in detail many operations of the Tennessee Valley

Authority including TVA's captive coal mines. The task force report stated:

> There are successful coal mines owned by utilities which serve the general utility and industrial markets. On the other hand most of the mines owned partially or totally by utilities which produce only for their parent company have been unsuccessful ventures. Several of these mines are for sale. Generally, utilities with coal mines have yet to prove that their mines can be run as efficiently as those owned and operated by commerical coal companies.

In view of this and the problems TVA has had with its own captive coal mine, the task force concluded that "TVA should avoid expansion of its coal mining program given existing operting problems and other utilities unfavorable experience with wholly owned coal mines."

There is one other factor in this equation which must not be ignored: electric utilities provide an essential public service under monopoly conditions. If diversification by a non-utility company increases the cost for that company's products, the customer has other options. That is not the case with the monopoly service provided by the electric utility companies today.

For all of these reasons considerable caution must be exercised in amending the Holding Company Act to premit or promote diversification. This view is shared by a number of State Commission respondants to the Corcoran letter. The Maryland Public Service Commission, for example stated "as long as the rate payers are not prejudiced by these activites (diversification) and funds are not siphoned from the regulated business to the unregulated activities, regulatory bodies should not be concerned. Our experience with the telephone industry, however, indicates that their are great difficulties in keeping these activities separate. The staff of this Commission would recommend that we approach any change in the status quo with caution."

Michael V. Hasten of the Illinois Commission in his letter to Congressman Corcoran noted that utility diversification appears to be in vogue. While he expressed no biases either way, he did state that as a regulator he had "serious concerns about unbridled, unregulated diversification which if left unchecked could inure to the detriment of not only current and future investors but also rate payers of public utilities." He concluded by stating that it was thus necessary "that regulators have tools available to them to be sure when they examine such proposals that diversification plans have sufficient safeguards to protect ratepayers and investors from abuse."

It is within this general context then that I would like to proceed to examine the proposals to amend the Holding Company Act contained in S.1174 insofar as they relate to diversification and to offer some suggestions with respect to alternatives.

Exempt Holding Companies and S.1174

In commenting on S.1870, 97th Congress, Kansas State Corporation Commission Chairman R. C. (Pete) Loux stated:

> The provision exempting holding companies created by companies presently exempt under Section 3(a)(2) of the Act would allow virtually any utility not presently subject to PUHCA to create a holding company, and thereby escape provisions of PUHCA. Removal of the "unless and except" clause, of course would require exemption of such holding companies whether in the public interest or not. Such provisions would have the effect of de facto repeal of PUHCA concerning companies not currently subjected to its provisions.

Admittedly, the amendments to Section 3 contained in S.1870 were more far reaching than those contained in S.1174. Specifically, where

S.1870 would have prohibited the SEC from refusing to grant or form subsequently withdrawing an exemption, S.1174 would preserve this authority but pursuant to a substantially altered standard. However, the bill does retain the provisions which, in the words of Mr. Loux, "would allow virtually any utility not presently subject to PUHCA to create a holding company, and thereby escape provisions of PUHCA."

Not only could companies not currently subject to PUCHA avoid that Act, the new exemption contained in new Section 3(a)(6) would permit them to avoid state regulation as well. This follows from the fact that, while new Section 3(a)(6) would require the public utility subsidiary to operate in the state of organization and contiguous states, the parent holding company could be incorporated in any state in the nation, or in fact any country in the world.

Contrast this to the requirements of existing Section 3(a)(2). Under that Section, an exemption may be granted to a holding company which is "predominantly a public utility company whose operations as such do not extend beyond the State in which it is organized and States contiguous thereto." Under that exemption, the parent holding company is also the utility and it must be organized in one state and operate in that and contiguous states.

By requiring the holding company to be organized within the state of operation the Act prserves the ability of state regulators to retain jurisdiction over the holding Company. However, by allowing a foreign corporation, that is, one incorporated outside of the state in which the utility is organized and operates to control that in-state utility, the amendments of S.1174 run counter to the underlying rationale for providing exemptions -- the presumption of effective state regulation. Under the amendment, a State Commission could regulate the utility but would be powerless to examine the operations of the parent company. The drafters of S.1174 recognize the fact that this new exemptive language could pose problems for state utility commissions. For that reason, they propose to add to the Act new section 3A dealing with State commission access to books and records.

The State commissions and their national association will undoubtedly have some comments to offer on this new section. While we would defer to their judgment, it appears to us that the rights provided state commissions are cumbersome to enforce any may be totally inadequate to allow them to protect the interests of consumers.

For example, new Section 3A requires that state commissions, prior to gaining access to documents, must be able to identify them "in reasonable detail." They are entitled to the documents so identified only if they can demonstrate that they are "necessary to the performance by the State commissions of functions imposed by law...." The burden to make such a demonstration is placed on the state commissions. It is difficult to imagine how these commissions could carry this burden.

In addition, it appears that such documents would only be available in the context of an on-going rate proceeding, a function clearly imposed by law. State commissions might not be able to obtain documents considered necessary to conduct oversight or general investigation harings unless such hearings were held to be commission functions "imposed by law."

As noted previously, S1174 would modify the standard under which the Commission may deny exemptions or repeal exemptions once granted. Under the Act, the Commission may deny or withdraw an exemption when it finds that the exemption is "detrimental to the public interest or the interest of investors or consumers." Under S.1174, the Commission could act only upon "specific factual findings made upon clear and convincing evidence that the exemption materially adversely affects the public utility business of such holding company system."

The incentive for this amendment, the concern that an exemption might be arbitrarily withdrawn, was expressed in the letter previously quoted from Atlantic Electric to Congressman Corcoran. But Atlantic Electric also noted that the current SEC interpretation of the existing standard is consistant with practices which would generally be followed by prudent utility managers. We suggest that the Commission has demonstrated no intent to repeal exemptions, and in fact has not even subjected to close scrutiny the operations of exempt holding companies. Until they do so we see no reason for Congressional modification of this aspect of section 3 of the Act.

We do agree with the exempt holding companies' suggestion that the "unless and accept" clause inhibits utility diversification. That clause is, in essence, a brake on unrestrained diversification activities. We think that, given the risks of diversification and the public service characteristics of the electric utility business, such a restraint, or brake, is entirely justified.

While the current "unless and except" clause provides a very effective brake on diversification, the new standard contained in S.1174 would virtually eliminate the effectiveness of that brake. SEC review would be confined to an examination of "material adverse affects" on the public utility business but could not extend to a review of the operations of the holding company itself. The SEC could not evaluate exemptions in light of the public interest. It would be impossible to make "specific factual findings" based on "clear and convicing evidence" that there would be a "material adverse affect" on the public utility business, as required under the amendment, at the time the exemption is requested. Thus, in all probability, exemption requests would have to be granted. Further, it seems highly unlikely that the standard could be met until after some harm had been experienced by the utility business. Thus, a major virtue of the Act, that is the prevention of abusive practices, is virtually eliminated.

Finally, we would note one other troubling aspect of the amendments to section 3, the requirement that exemptions be granted unconditionally. Presently, the SEC may condition the granting of exemptions and has done so to require the filing of information which permits it to monitor the exempt company's operations. Only with such information in hand can the SEC ensure that conditions are not being created which might be detrimental to the public interest or the interest of investors or consumers. We strongly recommend that the authority to condition exemptions be retained.

Should the Act be modified with respect to exempt companies? Frankly, we don't see the need. The Act in dealing with exempt companies, defers to state regulatory control, but provides the security of an emergancy brake to be applied if necessary.

However, there may be some room to fine tune the Act as it applies to exempt companies. For example, one of the concerns is the fear of withdrawal of exemptions previously granted. This issue might be addressed by a Congressional directive to the SEC to undertake a rulemaking proceeding to establish clear guidelines in this area.

There would be many benefits from this approach. First, parties would have an opportunity to present their views to the SEC. Second, guidelines would be established which could be varied only through another rulemaking proceeding. Third, Congress itself would have an opportunity to review the guidelines and determine whether or not they were appropriate. Finally, if the Commission at some future time determined that the guidelines were no longer appropriate, a new rulemaking would be required. This would provide time for interested parties to again submit their views and for Congress to act if it found that the Commission was abusing the discretion entrusted to it.

Registered Companies and S.1174

Under S.1174, registered companies could acquire anything less than a "significant interest" in non-utility enterprises without SEC review. In addition, they could exceed the "significant interest" limit through the filing of an acquisition application or a diversification plan. The application or plan would become effective unless specifically disapproved by the Commission. "Significant interest" is very generously defined as either "five percentum or more of the total consolidated assets of the holding company system or 10 percentum or more of the total consolidated assets of the holding company when taken together with the net assets as so recorded of all other interests acquired without Commission approval in any business other than the public utility business."

Acquisitions of less than a significant interest would occur without any regulatory oversight whatsoever. For companies with assets in the billions of dollars, even 5 percent of the total consolidated assets can be a very significant investment indeed.

Rather than allow registered companies to obtain anything less than a significant interest in any type of business, it seems far more reasonable, if any amendments at all are justified, to provide registered companies with a little more latitude to diversify into functionaly related enterprises. There may be beneficial consequences for such a diversification (although there are, as we have pointed out, possible detriments as well.)

Both the registered companies and the Commission have considerable experience with such diversification activities. Based on this experience, it might be appropriate to allow registered companies to diversify into functionally related areas, within carefully defined precentage limits and subject only to a minimal degree of prior Commission review.

Rather than the diversification premited under the "significant interest" standard contained in S.1174, the Congress might consider easing the restrictions on utility acquisition of functionally related enterprises, allowing such diversification within narrowly defined percentage limits, such as 5 percent of the net utility assets of the holding company system, but only with respect to acquisition of functionally related business. Whether the business to be acquired is in fact functionally related, should be determined by the Commission, and an affirmative order from the Commission to that effect should be required. The company proposing the acquisition should notify the

Commission of its plans and the Commission should then decide whether the acquisition is in fact an acquisition of a business which is indeed functionally related.

As previously noted, in addition to premitting the acquisition of less than a "significant interest" in non-utility property, S.1174 would allow acquisitions of non-utility property to proceed pursuant to an acquisition application filed with the Commission or pursuant to a diversification plan. In either case S.1174 would place the burden on the Commission to determine that the acquisition or the diversification plan was inappropriate rather than placing this burden on the registered company where it belongs, to demonstrate that the acquisition or plan was appropriate. Further, the Commission would be forced to act in a very short time to disapprove either the specific acquisition or the diversification plan. Disapproval would have to be based upon a finding that the specific acquisition or the plan would be "likely to result in an unnecessary and unreasonable increase in cost to consumers or impair the performance by any associated company which is a public utility company of its public utility service in a manner which is inconsistant with the service oblications of such company under applicable state law."

This standard would be nearly impossible to interpret. This is particularly true with respect to diversification plans. Diversification plans would cover a two year period of time, and would by their very nature be quite general. It is impossible to conceive how such a general diversification plan could be found by the Commission to be "likely to result in an unnecessary and unreasonable increase in cost to consumers or impair the performance of the public utility service obligations." As consumers, we don't see why we should be subjected to increases in cost resulting from diversification -- reasonable or unreasonable. In addition, how could the Commission differentiate between necessary and reasonable increases in cost to consumers as opposed to unnecessary or unreasonable increases in such cost.

If diversification into non-functionally related enterprises is to be allowed for registered holding companies -- and this is the real policy question which must be addressed -- we believe such diversification must proceed on a case-by-case basis. Specific Commission determination that each acquisition of a non-functionally related business enterprise would not be detrimental to the public interest and that there would be adequate protections provided for investors and consumers must be made. The burden should not be transferred from the companies to the Commission nor should such activities be allowed to proceed within a certain of period time if the Commission has been unable act. It is far more appropriate to ensure the protection of the public interest for the company to bear the burden of proof. The Commission should thereafter be allowed to determine whether the company's proposal would not create a situation detirmental to the public interest, or create risks for investors or consumers.

Following diversification of a registered company the Commission under S.1174 would be allowed to order divesiture, but only after it had made specific factual findings based upon clear and convincing evidence, that the retention of such an interest materially adversely affects the public utility business of such system. (This is the same standard to be applied under S.1174, in either disapproving an exemption or withdrawing a exemption previously granted.) The standard deprives the Commission of an opportunity to examine the impact of diversification activties on the public interest. Rather, the SEC would be confined solely to affects of diversification activities on the public utility business.

The Commission should not be deprived of an opportunity to take a global view, looking at the entire corporate structure of the holding company. Nor is it appropriate to prohibit the Commission from examining the operation of the entire holding company with an eye to determining whether or not situations are being created which are in fact detirmental to the public interest.

Intercompany Transaction

Closely related to the question of diversification is the issue of transactions between companies within the same holding company system. Under the Act, as interpretated by the SEC, transactions between a utility and non-utility companies within the same system are based on cost, plus a reasonable return. The SEC, however, takes into account profits earned by the non-utility company in its transactions with companies outside of the holding company system itself. By so doing, it may reduce the costs paid by the utility to the affilate thus providing benefits to the utility's customers. The bill would modify this, retaining the cost standard for such transactions which we support, but prohibiting the Commission from taking into consideration earnings or losses experienced by the non-utility company in transactions with other companies.

We could, perhaps, accept this amendment if a cap were placed on such costs. Specifically, we believe that the amendment should provide that in no event shall the Commission allow any price greater than the price of comparable contracts performed by persons who are not associate companies, or in a case of a contract for the sale of goods, not greater than the market price for such goods.

This cap on prices is the same cap proposed in S.1174 in the section allowing the Commission to permit a method of pricing which results in a price in excess of costs actually incurred in the performance of services or the provision of goods. Our recommendation would apply this to intercompany transactions in order to prevent utility consumers from paying excessive cost in cases where the holding company has failed to provide goods and services at a competitive price. Such situations have arisen, as noted previously, in the operation of captive coal mines. We believe such protection is a reasonable trade for amendments which would permit greater diversification by registered companies.

Acquisitions of Utitily Assets

Repeal of the Public Utility Holding Company Act would have eliminated SEC review of acquisitions of securities of a public utility or a utility holding company, and of utility assets. S.1174 not only preserves the authority of the SEC to reviw such acquisition but in fact strengthens the Commission's authority in this area.

Under the Act, SEC review of acquisitions of utility property by non-utility companies is not triggered until after a significant precentage of voting stock of a public utility has been acquired. After that threshold is reached, the SEC steps in, applying the statutory provisions, particularly those of Section 11, which may result in the registration and subsequent dismantlement of the entity just created. Allowing an acquisition to occur only to be followed by a divestiture is costly and detirmental to all concerned. Such situations have, however, arisen in the recent past. The Congress now has an opportunity to prevent them from arising in the future.

We believe the Commission should have the authority to consider the consequences of the application of the Section 11 requirements before an acquisition is consummated. Proposed Section 9(a)(3) would accomplish this result and we support this portion of the legislation.

It is significant to note that acquisitions of utility securities or utility assests S.1174 must be evaluated by the Commission under the existing standard which requires an examination of the potential detriment to the public interest or the interest of investors or consumers. Unfortunately, this is one of the few areas where the legislation specifically preserves the public interest standard for Commission review.

Review of Financings

The burden of SEC review of security issuances on registered utility holding companies has been discussed previously. It has been stated by registered companies that they must obtain prior SEC approvial of each security issuance. This is incorrect. The Commission has adopted a policy under which financial plans may be filed and once approved securities issued over a period of one year are allowed. This "shelf registration" approach could well eliminate many of the problems currently encountered by the registered companies.

Therefore, before the provisions of the Act dealing with security issuances are modified in any significant respect, we urge this Committee to examine the Commission's current practices and determine whether in fact any modifications are necessary.

Summary and Conclusion

Mr. Chairman we would offer the following in the way of a summary and conclusion.

First, we are past the point where it is necessary to debate the merits of the preservation of the Act itself. The Act is in the public interest and should be preserved.

Second, we are also past the point of debating the merits or demerits of utility diversification. It is unrealistic to suggest that utilities should be confined solely to the generation, transmission and distribution of electric energy.

Third, the debate therefore must focus on a limited number of issues. Specifically: What activities prohibited in the past should now be premitted and to what extent? If changes are to be made, specifically in the area of increasing the number of utilities entitled to exemptions, to what extent will these changes diminish effective state regulation of both the holding company and the utility operations? If activities previously prohibited are to be allowed should they be allowed unconditionally, or subject to some review? If subject to some review, then under what standards and who shall bear the burden of proof?

Because utilities provide an essential public service under monopoly conditions and because the past amply demonstrates the need for effective regulation, we urge the Congress to exercise great caution in premitting activities which have heretofore been prohibited. The Act in its present form recognizes both the strengths and the limitations of State commission jurisdiction over utility operations. The exemption categories of section 3 were based on this recognition. In contrast, the exemptions proposed in S.1174 appear to be designed to frustrate effective state regulation. We do not believe the exemption categories should be modified. The Commission should retain reasonable authority to deny any exemption application and to withdraw exemptions previously granted.

To what extent there should be federal review of diversification activities of utility holding companies and whether that review should be active, requiring affirmative regulatory approval, or passive, in the nature of an emergency brake, should vary from situation to situation. For exempt companies, the passive review and reliance on the good faith filings seems entirely appropriate. But certainly the emergency brake should be retained.

For registered companies it may well be that some additional latitude to diversify is appropriate although we remain skeptical that such a change would be beneficial. Such latitude could be provided to allow registered companies to diversify into functionally related areas, subject to certain size limitations and a Commission determination that the activities proposed are in fact functionally related. Diversification into non-functionally related areas by registered companies should not be allowed to proceed except on a case-by-case basis following review and approval by the SEC.

In the case of security issuances by registered companies, some additional flexibility may also be appropriate. We believe, however, that the Commission has taken steps in this direction and the Congress should therefore determine whether the recent actions of the Commission adequately address the problems encountered by the registered companies.

With respect to the acquisitions of securities of utilities or utility holding companies or the acquisition of utility assets, clearly continued SEC jurisdiction is essential to protect the public interest. In addition the SEC should be granted the authority to review proposed acquisitions by non-utility companies before they are consummated to ensure that subsequent registration and compliance with the requirements of the Act would not be detrimental to the interests of the public or harm investors or consumers.

We do not see any justification for changing the review standards currently in the Holding Company Act. There has been no evidence of SEC abuse of its discretion in the administration of these standards. If the SEC abuses its discretion in the future then Congress can, at that time, determine whether the standards should be modified.

As with active or passive review of various activities, the burden of proof will vary from situation to situation. With respect to granting or withdrawing exemptions or forcing divestiture, the burden should be on the Commission as it is now to demonstrate that it's proposals are necessary to prevent or remedy situations detrimental to the public interest or the interest of investors or consumers. If more liberal rules are to be applied for diversification by registered companies, then those companies should bear the burden of demonstrating that their proposals will not be detrimental to the public interest or the interest of investors or consumers. Likewise, utilities or non-utility companies proposing to acquire utility securities or utility assets should bear the burden of proof.

Mr. Chairman that concludes my remarks. I have tried to offer constructive comments which I hope will be beneficial to you and your colleagues as you proceed to review proposals to amend the Public Utility Holding Company Act of 1935.

ATTACHMENT

CURRENT FINANCIAL CONDITION
OF INVESTOR-OWNED ELECTRIC UTILITIES

The financial health of investor-owned electric utilities has improved significantly over the past two years and is sound. Important economic factors which contributed to the alleged economic difficulties of the investor-owned electric utility industry have changed. The industry's market-to-book ratio has improved along with other indicators of financial health such as return on equity, interest coverage ratios, and net income. The decline in the rate of inflation has lowered interest rates and, in turn, utilities borrowing costs.

High inflation and interest rates were primary factors depressing the industry's market-to-book values. During the third quarter of 1981 the annual inflation was 13.5 percent, but has declined to 2.1 percent during the first quarter of 1983; this is less than one-sixth the 1981 rate. Similarly, yields on public utility bonds have declined by 16 percent: from 15.87 percent in July 1981 to 13.31 percent in March 1983. This 16 percent decline was equal to the decline in domestic bond rates in general.

The industry's market-to-book ratio was 76 percent in July 1981, and has increased to 100 percent in April 1983. In addition, the industry's net income has increased substantially over the past two years: in 1982 it increased by over 20 percent and in 1982 by almost 19 percent.

These increases in net income have continued through the first quarter of 1983. Business Week's survey of 875 of the country's largest corporations in 39 key industries shows that first-quarter profits of these firms declined by 1 percent, but the combined profits of 22 large electric utilities included in Standard & Poor's 500 leading corporations increased by almost 9 percent. Over the past ten years the levels and percent increases in the net income of investor-owned electric utilities were:

	NET INCOME (Millions)	PERCENT CHANGE
1982	15,030	18.8
1981	12,656	20.2
1980	10,529	13.2
1979	9,302	8.5
1978	8,574	9.7
1977	7,813	11.8
1976	6,990	16.5
1975	6,002	16.6
1974	5,146	6.1
1973	4,851	11.4

The improved earnings of electric utilities have led industry observers to comment:

> "Even under divergent interest rate scenarios, utilities look attractive. If current downward yield curve shifts are only a respite on the way to rising rates, income-oriented investors will find electric utility common stocks appealing, for they withstand a hostile interest rate environment better than bonds. Conversely, if interest rates edge downward further, a positive tone will probably continue to dominate investor attitudes toward these stocks." ("The Electric Utility Industry," Lehman Brothers, February, 1983)
>
> "...The stocks that constitute the Dow Jones utilities group have outperformed the Dow Jones industrials by a margin of almost 2 to 1, the utilities have advanced 20.9 percent, the industrials 11.6 percent." (Forbes, March 28, 1983)

Even the Edison Electric Institute (EEI) has acknowledged the industry's improved financial condition. In February 1983, William McCollam, president of EEI, noted the significant amount of industry rate increases in 1982 and the improvement in market-to-book ratios. Also, he stated that pre-tax interest coverage had increased from 2.57 times in 1981 to 2.71 times in 1982. In addition, EEI recently announced that the average return on equity increased from 12.6 percent in 1981 to 13.4 percent in 1982.

The significant improvement in the industry's financial condition over the past two years cannot be explained away by the fact that an allowance for funds used during construction (AFUDC) is included in the net income reported by the industry. EEI has noted that AFUDC is an accounting entry and is only converted to cash when facilities under construction are complete and in operation. EEI further notes that AFUDC represented 47 percent of utility net income in 1982 and 43 percent in 1981. However, even after excluding AFUDC, the following data show that electric utilities still posted impressive gains:

	(MILLIONS)	PRECENT CHANGE
1982	$ 7,966	11.1
1981	7,167	21.4
1980	5,902	5.9
1979	5,575	(1.6)
1978	5,667	4.1
1977	5,446	6.9
1976	5,094	18.2
1975	4,308	21.4
1974	3,550	(0.1)
1973	3,554	9.0

This profit performance over the past ten years, and especially over the past two, has enabled the industry to raise $13.1 billion in new capital in 1981 and $13.9 billion in 1982. All the above financial data indicate that the industry's financial health has improved significantly over the past two years and is currently sound.

Statement of Great Lakes Electric Consumers Association
Before
Subcommittee on Securities
Senate Committee on Banking, Housing, and Urban Affairs
S. 1174 - Public Utility Holding Company Act
Submitted by Frank W. Frisk, Jr. Executive Director

The Great Lakes Electric Consumers Association, which represents municipal electric utilities and rural electric cooperatives in Delaware, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, New Jersey, New York, Ohio, Pennsylvania, West Virginia and Wisconsin, wishes to expess its strong opposition to proposed amendments to the Public Utility Holding Company Act.

This 1935 statute was designed by Congress to stop the private utility abuses of that period and prevent them from reoccuring. Those abuses included such matters as witholding accurate information from investors; subsidiaries charging excessive costs borne by the consumer; holding company control of subsidiaries caused manipulation of rates, dividends, and accounting practices; growth of such holding companies bore no relationship to economy of management; and, the abuses caused lack of efficiency and poor service. All of these abuses are spelled out at the beginning of the Act, along with the clear statement that the Holding Company act is necessary to protect the "public interest."

The question before Congress is clear. What will happen if the Holding Company Act is destroyed? Answers are not easy to give, but every consumer in the nation should be aware of what the Act has prevented since 1935. There is no question that complete monopolization of the electric industry has been thwarted. Competition is the rule, not the exception. By taming the holding companies in 1935, Congress allowed competition to thrive at the wholesale and retail levels, with rural electric cooperatives, municipal electric utilities, private companies, and the federal govenment all planing a role in holding costs down for the consumer because of active competition.

Today's arguments for changes in the Holding Company Act are short sighted, and never mention the abuses stopped by Congress. Without the Holding Company Act protections, what is to prevent those old abuses from appearing again, perhaps in slightly different forms, but the potential is there, and constant protection of consumer-oriented legislation is a must for this and every other Congress. Difficulty in financing is not unique to private companies concerned with the Holding Company Act. All utilities, public, cooperative, private, and federal have experienced the recent high interest rates, shortages of funds, and the general effects of an economic downturn.

Simply addressing one part of the legislation before this Congresss shows why it should not be enacted. Instead of using the "public interest" standard as a guide, the Securities and Exchange Commission would apply the phrase "an unreasonable econcomic risk to investors or consumers," in prohibiting an act by a holding company subject to its jurisdiction. The public interest standard is found in numerous acts of Congress, and has been proven to be an effective standard by which to measure regulated activity. It is flexible, and is applied to meet changes in economic conditions as they arise, as well as other regulatory areas. There is no known precedent for the new proposed regulatory standard. What is an "unreasonable economic risk?" The very nature of the phrase implies that investors will be guaranteed some protection not now granted. It that true? Regulation under the Holding Company Act, for example, insures that utilities do not destroy their economic base by venturing into other potentially riskier fields. Such a phrase also ignores the obvious fact that some investors prefer high risk speculation (unusual now in the utility field, but possible if the Act's protections against diversification are lost.) in hopes of higher returns.

There is simply no policy reason why the consumer should suffer from large infusions of capital by private power holding companies into other industries. Such infusions could destroy existing competitive industries. Utilities are now in a situation where surplus capacity exists in all parts of the nation. The challange is not to allow entry into other non-utility areas, but to seek ways fo utilizing surplus power to promote industrial growth, new urban and rural uses, and methods of displacing oil and natural gas. Allowing private company management to neglect the effort of supplying the vital service of electricity in favor of non-utility related enterprises is contrary to sound national policy.

For example, in the Great Lakes area, an upgrading of the existing transmission system could allow transfers of power within and from without the region at a lower cost to consumers. That will take some capital expenditure, but the dividends to consumers could reach billions over a period of years. Of particular interest is the building of an East-West Intertie allowing exchanges and sales of power between two vast parts of the nation. The underlying purpose of this bill - allowing non-utility enterprises to be engaged in by private power companies is wrong.

Our nation's power system needs all the effort possible in this economy. Our electric future is at stake, depending on whether we build and redesign for the future, orlet one segment, the private power companies, rest and search for other industrial enterprises. This legislation would cause the electric consumer to suffer by its very nature.

GLECA objects strongly to the use of the word "consumer" in this legislation, defined as purchasers from a subsidiary. This could exclude the right of rural electric cooperatives and municipal electric utilities to challenge matters before the SEC.

GLECA also supports the analysis performed by the American Public Power Association showing that wholesale power rates to consumer-owned electric systems could rise under this legislation, by having non-utility subsidiaries charge high prices to other subsidiaries within the same holding company system, rather than competitive system purchasing.

The Great Lakes Electic Consumers Association objects to further consideration or passage of S.1174, or similar legislation amending the Public Utility Holding Company Act.

Senator D'AMATO. Let me thank you not only for your thoughtful presentation but also for your testimony which we have taken into the record. You have presented some thought-provoking ideas and concern that I think we have to look at. I'm particularly intrigued by your testimony on page 25 and 26 which states:

> The bill would modify this, retaining the cost standard for such transactions which we support, but prohibiting the Commission from taking into consideration earnings or losses experienced by the nonutility company in transactions with other companies.
>
> We could, perhaps, accept this amendment if a cap were placed on such costs. Specifically, we believe that the amendment should provide that in no event shall the Commission allow any price greater than the price of comparable contracts performed by persons who are not associate companies, or in a case of a contract for the sale of goods, not greater than the market price for such goods.

Would you care to amplify on that? I always look for ways in which we can accommodate and deal with legitimate problems and concerns that may exist and I think this testimony is a pretty good starting point.

Mr. RICHARDSON. Well, let me state first that this is not a proposition which has gone through any kind of mill, so to speak, through the association. It was offered as a possible suggestion in response to the amendments contained in the act.

It seems to me, however, that if the legislation is going to say that costs for these transactions or the prices of these transactions are to be based on actual costs, a proposition we support, but that they don't have to take into consideration the profit and losses as is currently the case through the SEC administration of such transactions, a tradeoff for that could well be a prohibition on the cost exceeding market level. This would be particularly important, for example, in the coal mining area where utilities with captive coal mines have ended up paying significantly greater than market price.

Senator D'AMATO. Who should be regulating these transactions the SEC, the FTC, or the Justice Department?

Mr. RICHARDSON. We don't see any reason why it should not be the SEC as it has been in the past. These are corporate transactions which result from the holding company structure and the financings or corporate activity, and we think the SEC is the logical repository for those responsibilities.

Senator D'AMATO. Of course, the SEC doesn't feel that way.

Mr. RICHARDSON. The SEC does not feel that way; that's correct.

Senator D'AMATO. They don't feel that this area should be within their purview because it involves evaluating business, judgments, et cetera, as well as the problems of cross-subsidization.

Mr. Richardson, didn't you say that the utilities really don't need to diversify because their industries are healthy?

Mr. RICHARDSON. No. If that's the impression that you've gotten from my testimony, that is not the impression I meant to give. The interest in diversification last year it seems to me was financial distress.

Senator D'AMATO. Yes.

Mr. RICHARDSON. There have been changes in the financial condition of the utility industry and, in addition, at a time of financial distress it seems to me to be the most inappropriate for utilities or any other business to look elsewhere.

The thing to do in that case is to get their own house in order first.

Senator D'AMATO. There appears to be a great deal of similarity between the issues raised in your statement and those which were raised yesterday by our panel of State regulators. However, yesterday's panel seemed a little more positive regarding S. 1174's attempt to preserve fundamental safeguards. In fact, they sounded a bit optimistic about reaching a compromise on S. 1174.

Since you and the State regulators share similar protective mandates, do you feel that your bottom line is the same as theirs? Basically, do you think that there's an area of compromise with respect to S. 1174 that you could support?

Mr. RICHARDSON. I think there are areas of compromise, yes. Whether our bottom line is the same as their bottom line is impossible to know. We know what our bottom line is because it's been dictated by our membership through the adoption of a formal resolution. We won't know what their bottom line is until they come forth with a proposition which they support.

I think we do share the same views in one very major point raised by Dr. Schuler and Chairman York. Our major problem is with the standards to be applied and the burden of proof.

Senator D'AMATO. Is that your major problem?

Mr. RICHARDSON. That is our major problem; yes, sir.

Senator D'AMATO. All right. We'll take that into consideration.

Mr. RICHARDSON. Now there are other problems as well, but that is our major one.

Senator D'AMATO. Is there a laundry list?

Mr. RICHARDSON. The long list is contained in my statement, yes.

Senator D'AMATO. Well could you possibly cut down that statement and narrow the list to one side of this yellow pad?

Mr. RICHARDSON. With six-page doubled spaced——

Senator D'AMATO. That is quite a laundry list.

Mr. RICHARDSON. This was prepared some time ago in trying to crystallize my own thoughts and in fact major problem areas are identified as exemptions, financing, and——

Senator D'AMATO. Let's talk about financings? Then we'll talk about diversification.

FINANCINGS

Mr. RICHARDSON. I must admit I'm considerably less familiar with the issues in this area than I am with the issues of diversification.

As you know as a Member of Congress, if you control the purse strings you can control many activities. It's perhaps comparable in controlling the financings of holding companies, that it gives them control.

UTILITY COMPANIES INVOLVEMENT IN REHAB PROJECTS

Senator D'AMATO. Alright then—let's look at diversification. Should utilities get involved in rehabilitation projects?

Mr. RICHARDSON. Should they be allowed to get involved in rehabilitation projects?

Senator D'AMATO. Yes.

Mr. RICHARDSON. It depends on the magnitude of the investment and the possibility of detriment to the utility system and the holding company structure.

Senator D'AMATO. Well, supposing they could lose $5 to $8 million in these projects, which is a significant risk then, should a utility company become involved in these neighborhood revitalization programs?

Mr. RICHARDSON. We've crossed that threshold I believe in recognizing that perhaps some additional diversification for registered companies could be appropriate. The question is the magnitude. If it's a $5 or $6 million investment and you have a $10 billion system, the chance of an impact on the utility system it seems to me to be minimal.

Senator D'AMATO. We have a dialog here on whether the limits on diversification should be 10 percent or 5 percent of capital as opposed to 10 percent of assets. There is a great difference between these limits. Would it be prudent to set limits?

Mr. RICHARDSON. I think it would be prudent to set limits, yes.

Senator D'AMATO. You heard the dialog between Chairman Shad and myself, about possibly phasing limits. Aren't companies diversifying now without limits?

Mr. RICHARDSON. There are companies with no limits but all are subject to the "unless and except" clause in section 3 and, of course, operating in a single State so that the State commission has not only control over the utility operation but over the holding company as well.

Senator D'AMATO. Should we hold these other 12 companies in bondage and preclude them from engaging in some of these kinds of activities?

Mr. RICHARDSON. What we are suggesting I think is that it may well be appropriate to provide additional latitude for diversification into other businesses. There are restraints and we think restraints are very appropriate because we are dealing with public utility property. We are not dealing with Sears and Mobil. I can go to another gas station or another department store. I can't go to another utility.

Senator D'AMATO. I think you understand that I share that concern and that's why I asked the question. Again, shouldn't we allow those companies who are outside this act now and who would like to form holding companies the opportunity to do so? I see tremendous potential, again, in allowing utilities to become involved in restoring these neighborhoods. It is important to their interests in that it prevents their customer base from shrinking. Moreover, the rehabilitation of neighborhoods, inner cities, and urban areas is important to stockholders, and to the general public——

Mr. RICHARDSON. Of course, to their ratepayers as well.

Senator D'AMATO. Of course, it benefits ratepayers too.

Mr. RICHARDSON. It could well have a beneficial impact. It could also have a detrimental impact. And that, of course, is a major concern.

Senator D'AMATO. I want to thank you very much for your comments. I'd like to see even a six-page double spaced laundry list.

Mr. RICHARDSON. The major problems are only three pages.

Senator D'AMATO. Only three pages? That's better.

Mr. **Richardson**. I'm sure I could reduce those three pages of double spaced into single spaced yellow pad piece of paper, so I will simply give you the entire six-page document.

Senator D'**Amato**. OK. Why don't you attempt to put down your major concerns. Maybe we can eliminate some of those.

Mr. **Richardson**. Perhaps we can.

Senator D'**Amato**. Maybe we can resolve some of the differences, in a manner which would make S. 1174 even better.

Mr. **Richardson**. Fine.

Senator D'**Amato**. Thank you very much.

Mr. **Richardson**. Thank you, Mr. Chairman.

Senator D'**Amato**. Our next and last panelist is Mr. Barr, principal, Morgan Stanley & Co., New York. Good morning.

STATEMENT OF JOHN W. BARR, PRINCIPAL, MORGAN STANLEY & CO., INC., NEW YORK, N.Y.

Mr. **Barr**. It's nice to see you, Mr. Chairman. I have a 5-minute summary of my remarks if it would be appropriate to give that, and then I would be pleased to answer any questions.

Senator D'**Amato**. It would be most appropriate.

FULL REPEAL IS THE PROPER SOLUTION

Mr. **Barr**. Mr. Chairman, when I testified before your committee a year ago I strongly supported full repeal of the Public Utility Holding Company Act. Today we still believe that a full repeal of the act is the proper solution to the problem.

I'm here today, however, to support S. 1174 which we think is a step in the right direction and which will serve the best interests of both investors and consumers.

As a participant in the capital market, I would like to discuss briefly three aspects of the bill which are of special interest to investors.

First, the ability of utilities, including both registered and exempt companies, to diversify. Second, the removal of obstacles through the use of the holding company form of organization by utilities which are now exempt from the act. And, third, the undue financial restrictions which the act imposes on registered holding companies.

S. 1174 endeavors to remove unnecessary obstacles which now restrict the ability of the electric and gas industries to diversify. We believe that investors do favor diversification and most certainly they favor the right of companies to diversify. More than 50 percent of the goods and services produced in this country come from diversified companies. Since diversification is a strategic alternative available to any nonregulated company, it should not be denied as an option to utilities. It is not as if we were talking about a rare and dangerous experiment in corporate America to permit utilities to diversify.

Mr. Chairman, in previous testimony I've established the basic fundamental reasons that investors favor diversification. I'd like to pass over those if I may and continue with my summary.

A second important objective of the bill is to make it easier for exempt utilities to diversify using a holding company corporate structure. We believe that the holding company form of organization very often provides for the most economic and logic deployment of corporate assets. This is especially true for utilities for which proper segregation of regulated and nonregulated businesses is essential.

At the current time, because of the 1935 act, exempt utility companies are wary of forming and using the holding company structure. We believe that the provisions of S. 1174 which address these problems are consistent with the objectives of both investors and consumers.

REDUCING FINANCIAL RESTRICTIONS

Another important objective of the bill is to improve the financial possibility of the registered companies by reducing the financial restrictions in the act. Currently, the act requires these companies to seek SEC approval for each issue of securities which those companies do in the capital markets. For many years these requirements have drastically limited the financial flexibility of the registered companies. These utilities are unable, without prior approval, to change the types of securities to be issued, the specific terms of the securities, or even the market in which the securities will be sold. In the rapidly changing market conditions which have characterized the financial markets in recent years these companies have been placed at a severe disadvantage compared with exempt utilities and industrial companies.

The act hinders these companies from taking advantage of new financing techniques or short-lived market opportunities and clearly makes their financings more difficult and often more costly.

Although the SEC's 1935 act division, to its credit, has made efforts to streamline its financings approval process for registered companies, these efforts unfortunately have only increased uncertainty and confusion.

Regulatory unpredictability when added to market uncertainty only compounds the difficulty of financing by these registered companies.

These companies do not need to have one hand tied behind their back by unnecessary regulation. We see no legitimate reason for the SEC's 1935 act division to be involved in the financial decisions of these companies. It is not well situated to pass judgment on financial decisions which must be based on market information and experience. Rather, we recommend that financing decisions for the registered holding companies be made, as they are made for and by all other companies, solely by the utility with the advice of its financial experts.

One final area, Mr. Chairman, that is not addressed by the bill is the requirement for competitive bidding of public securities by the registered companies. Under rule 50 of the act, which is a rule established by the SEC not by Congress, these companies must sell their securities through competitive bidding unless a specific exemption is obtained from the 1935 Act division to permit a negotiated financing in which the company selects its underwriters.

Experience has shown that these exemptions are infrequent and difficult to obtain. It is our hope that S. 1174 will include an elimination of rule 50. This will increase the financial flexibility of the registered companies by allowing them to choose their method of sale. In some markets, competitive bidding may achieve the lowest cost of borrowing. In others, a negotiated sale clearly will achieve a lower cost and a more successful issue. But it is the utility, not the SEC, which is best qualified to make that judgment.

Registered companies should be able to choose the method of sale of their securities with the same freedom as other utilities.

In summary, in the absence of complete repeal of the act, we support S. 1174. We believe it represents meaningful modification of the act and is one way the Government can streamline regulation while at the same time aiding capital formation for one of the most important U.S. industries.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT

OF

JOHN W. BARR
PRINCIPAL
MORGAN STANLEY & CO. INCORPORATED

My name is John W. Barr. I am a Principal of Morgan Stanley & Co. Incorporated and am involved with my firm's financing and advisory activities with the public utility industry. Morgan Stanley is a leading investment banking firm in the underwriting and placement of securities for corporations. We provide investment banking services to a broad group of client companies in the electric, gas and telephone sectors of the utilities industry, including selected registered public utility holding companies. As an investment banking firm, we are in continuous contact with all major institutional debt and equity investors numbering over 1,500 in this country and abroad. In addition, as a leading investment bank in the mergers and acquisition business, we have extensive practical experience on the subject of diversification.

I had the privilege of testifying before this Subcommittee a little more than a year ago on the subject of the repeal of the Public Utility Holding Company Act. I appear today in support of the proposed legislation (S.1174), a bill which would modify, but not eliminate, the Public Utility Holding Company Act. Although we continue to believe that full repeal of the Act is the proper solution to the problem, it is our view that the compromise position provided in S.1174 is good legislation which is in the best interests of both investors and consumers. Speaking as a participant in the capital markets, I will discuss three aspects of S.1174 of special interest to investors: the elimination of obstacles to diversification by both registered and exempt holding companies, the removal of uncertainties relating to the use of the holding company corporate structure by exempt utility companies and finally the provisions removing unnecessary financial restrictions on registered holding companies.

Diversification

The proposed modifications would remove unnecessary obstacles which now restrict the ability of the electric and gas industries to diversify. We believe that investors favor diversification and certainly favor the right of companies to diversify. Diversification is a strategic alternative available to any non-regulated company. It should not be denied as an option to utilities. I will summarize the principal reasons why we believe diversification should be permitted:

1. Diversification can provide another base of earnings to reduce the risks associated with exposure to a single line of business. There can be no question that the utility (especially the electric) business has become riskier over the past decade. Clearly, staying in one line of business has hurt the capital formation capability of utilities; diversification can help to improve this vitally important process.

2. Diversification enables utilities to utilize their existing strengths and assets to their fullest. In addition, upstream or vertical integration may enable utilities to secure fuel and other supplies for the decades ahead.

3. Through diversification, utilities may be able to earn a higher overall rate of return than they have been able to earn on utility business. Diversification can increase earnings per share without increasing rates charged to utility customers and should improve market-to-book ratios, one of the best indicators of the stock market's perception of a utility's financial strength or weakness.

MORGAN STANLEY

4. Studies indicate that investors will, on balance, pay higher prices for securities of diversified utilities than for non-diversified utilities. In addition, a diversified utility may broaden its appeal and attract new investors who would not otherwise be buyers of its securities. This will enhance the capital formation process for diversified utility companies.

Holding Company Corporate Structure

The proposed modifications will also remove obstacles to the use of a holding company corporate structure by exempt utilities. As experts in financial organization, we believe that the holding company is a form of corporate organization which may, under many circumstances, provide the most economic and logical deployment of assets. This is especially true for utilities for which proper segregation of regulated and non-regulated assets and earnings is essential. At the current time, because of the Act, exempt utility companies are very wary of forming holding companies even though this corporate structure may best serve the interests of both investors and consumers. We believe that the provisions of S.1174 which address these problems will be well received by investors.

Financial Flexibility

Another major contribution of S.1174 is its modification of financial restrictions in the Act, which should improve the financial flexibility of the registered holding companies. At the current time, under the Act, registered holding companies are required to obtain prior SEC approval of each securities issue. Our experience, as a leading underwriter for the utility industry, is that this requirement drastically limits the financial flexibility of the registered holding companies. Without prior approval, these utilities cannot change the types of securities to be issued, the specific terms of the securities or even the market in which the securities will be sold. In the rapidly changing market conditions which have characterized the financial markets since the late 1970's, registered utility holding companies have been placed at a severe disadvantage compared with exempt utilities and non-utility companies. The Act's financing constraints prevent these companies from taking advantage of new financing techniques or short-lived market opportunities, and clearly make financing by registered holding companies more difficult and often more costly than necessary.

To its credit, the Holding Company Act Division of the SEC has made efforts to streamline its financing approvals process for registered holding companies. Its efforts to date, however, have tended only to increase uncertainty and confusion for registered companies seeking to sell securities. Unfortunately, market volatility and the ability of other capital raisers to enter the market quickly have both increased faster than regulatory flexibility. As a result, the cost of inadequate financing flexibility has grown. The utility industry must compete for funds with industrial companies, the U.S. Government, and other issuers in the capital markets. Year in and year out this industry raises more capital than any other U.S. industry and it must do so from a position of continuing financial decline.

Registered holding companies do not need to have one hand tied behind their back by unnecessary regulation. We see no legitimate reason for the Holding Company Act Division of the SEC to be involved in the financial decisions of these companies. It is not well-situated to pass judgement on financial decisions which must be based on market information and experience. Rather, we recommend that financing decisions for the registered holding companies be made, as they are for all other utilities, solely by the company with the advice of its financial experts.

One area not addressed by S.1174 is the requirement for competitive bidding of public securities by the registered holding companies. Under Rule 50 of the Act (a rule established by the SEC, not by Congress), these companies must sell their securities through competitive bidding unless a specific exemption is obtained from the Holding Company Act Division to permit a negotiated financing, in which the company selects its underwriters. (Experience shows these exemptions are infrequent and difficult to obtain.)

It is our hope that modification of the Act will include an elimination of Rule 50, which will greatly increase the financial flexibility of the registered holding companies. Utilities have shown that they are fully capable of deciding when to issue securities by competitive bidding and will do so readily when market conditions warrant. In some markets, utilities may achieve the lowest cost of borrowing through competitive bidding. In others (for example volatile or difficult markets), companies, especially those which are financially weak, will clearly do better through a negotiated sale. Either method of offering securities should be readily available to registered holding companies.

In summary, absent complete repeal of the Act, we support the proposed modification of the Act through adoption of S.1174. This legislative action will remove obstacles to diversification by the utility industry, allow the use of a corporate structure well suited to many utility companies and also improve the financial flexibility for the nation's registered holding companies. Furthermore, we urge Congress to eliminate Rule 50 -- a restriction limiting financial flexibility for these companies. Meaningful modification of the Act is one way the Federal Government can streamline burdensome regulations, while, at the same time, aiding capital formation for one of the most important U.S. industries.

Senator D'AMATO. Thank you very much for once again giving of your time.

I'm only going to ask you two questions, Mr. Barr.

Mr. Richardson suggested that the current regulatory framework for utility financing is adequate. Would you respond to that with a view toward how burdensome the current system is elaborating, on those burdens? Also, how do these burdens affect the holding company's cost of capital?

Mr. BARR. We are most familiar, Mr. Chairman, with the day-in-day-out process by which registered companies under the act carry out their financing programs. We have seen in many instances over the years, cases where those companies are required by the existing provisions of the act to make commitments to the kind of financing that they will do, and, to the market in which they will do those securities, far in advance of the time when this decision is best made. We all know the bond market and stock market have become far more volatile in recent years. As a result, the company that can move quickly, making changes in its terms of issue up to the last minute of pricing, can often get the best issuance in the market and achieve the lowest cost of borrowing. When there is an additional layer of regulatory approval necessary and often an education process—an advocacy which is necessary to convince regulators that some change be made—the market opportunity may be long past by the time the company is able to act on it.

Senator D'AMATO. It's been suggested that a shelf-type registration is currently permissible under the 1935 act and that S. 1174's provision is unneeded. Would you comment on that?

Mr. BARR. I will try to comment. I think that rule 415 was an attempt to streamline procedures under the 1933 act. It has done that, and it has been broadly used by industrial companies and nonregistered utilities.

However, I don't see how the streamlining that rule 415 affords the market and the users of capital markets has any effect on the existing financial restrictions in the 1935 act. In fact, if anything, Mr. Chairman, I think that the example of the rule 415 would suggest that a similar streamlining and reduction of unnecessary regulatory delays would be appropriate for the 1935 act.

Senator D'AMATO. Mr. Barr, I want to thank you very much for your testimony and for your thoughts in this area. We rightfully raised objections and some fears and anxieties believing this would not be in the best interest. We've now moved toward amending and dealing with those areas of concern, attempting at least in this legislation improve the business climate and yet recognize our responsibility to the general public because these are public utilities in the final analysis. Specifically, we are attempting to balance the need to protect the public, the consumer, et cetera, and yet, give the corporate structure and management flexibility in decisionmaking, et cetera, which as a practical matter will serve that same interest, and constituency; the users, the consumers, the investors, et cetera.

They are not competitors and those are not competing objectives. Those objectives I think are rather similar and the interest groups really are all tied together in search of a healthy economic environment.

Mr. BARR. Mr. Chairman, we would certainly agree that the interest of consumers and investors seem to be very congruent in these actions.

If I could add one last point, I sensed in your earlier questions this morning that you were still wondering whether the right point of compromise would be 5 percent of capitalization or 10 percent of assets.

Senator D'AMATO. Would you care to comment on that?

Mr. BARR. Yes, sir; I would. I think from the investors' standpoint that the probable dollar amount of earnings that would come from a company under the 5-percent rule would be so slight and insignificant compared to the total earnings of the company that it would not be very much noticed by the market and would probably not be a factor in valuing the common stock of the company. It would be somewhat of a nonevent. I think that, in view of the stock market, if a company is earning such a small percent of its earnings from diversified activities, it really is not diversified and the risk is that that condition would lead utilities to say "why bother?"

So we would certainly support 10 percent as the better limit.

[Response to question of Senator D'Amato follows:]

MORGAN STANLEY

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INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

June 21, 1983

Senator Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

Thank you for the opportunity to participate in your recent hearings on modification of the Holding Company Act. We are very encouraged by the progress which the Subcommittee is making on this issue under your leadership.

In follow-up to your question about the level of permissible diversification, we reiterate our views that the Bill's 10% of asset test is reasonable and prudent. We could support a smaller percentage only if very specific guidelines are included in the legislation by which the 10% of asset level could be achieved over a relatively short (e.g., two-year) period. We believe it is important that any "phase-in" to this higher level be specified in the legislation so as to reduce uncertainty for both investors and management.

One of the underlying principles at issue in the proposed legislation is whether utility management or the SEC should have the right to make decisions for a company. It is our view that management is eminently more qualified than the SEC to decide how much and what kind of diversification should be pursued. Since management is ultimately held responsible for all decisions relating to diversification and financing, we believe that it should be allowed to act with full discretion.

Please let me know if we can be of any further assistance.

Sincerely,

John Barr

John W. Barr
Principal

Senator D'AMATO. Of course, the problems with that is, I wouldn't want to wake up and learn about an unsuccessful venture which severely adversely affects the public. There have been those who have gone a little bit astray and have lost millions of dollars, so, we have to be careful. I do, however, understand the other side. If we are so limiting in terms of the amount of capital that will be available for diversification we might chill it. Therefore, there is that need for balance, particularly in the initial stages, and that's why I suggest with Chairman Shad that there might be a phase-in period to see just how things would work. You know, there are corporate management teams who see a pot of gold and rush in. We've seen that in the banking area, in the securities area, and other areas.

I remember that the major bankers thought they could go out to the suburban communities and upstate communities and just pick up all that business when State branching regulations were relaxed. And, of course, we've seen many of these major institutions close down, sell off and literally give away branches sometimes absorbing tremendous losses because they had rushed into these new ventures. So no one can really say that there is a formula for good, prudent corporate management, whether it be in the banking institutions or the securities areas or insurance companies or utility companies. Therefore, we've got to be careful about this as well.

I thank you very much. And this committee stands in recess.

[Whereupon, at 10:40 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING, and URBAN AFFAIRS
UNITED STATES SENATE
ON THE
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
June 28, 1983

Introduction

The American Gas Association is a national trade association comprised of nearly 300 natural gas distribution and transmission companies serving over 160 million consumers in all 50 States. Collectively, A.G.A. member companies account for nearly 85% of the nation's total gas utility sales annually.

Natural gas currently provides about 27% of the energy consumed in the U.S. Gas is used in about 55% of all domestic residential and commercial establishments, and it provides 40% of the energy consumed by domestic industry, including agriculture. Almost all gas used in the U.S. is produced domestically, and natural gas provides two and one-half times as much end use energy to consumers as electricity. Thus, natural gas is a vital part of this country's energy mix.

You are well aware that there have been a number of bills before Congress in the past two years that proposed to deal with regulatory reform. As an industry that is probably more comprehensively regulated -- at both the State and Federal levels -- than any other field of business, the gas industry has actively considered and commented upon such legislation. Basically, most bills have been omnibus legislation that is equally applicable to all agencies. However, the gas industry believes that a "broad brush" approach would be largely ineffective -- or even counterproductive. True regulatory reform requires examination by Congress of the statutory charters of each agency, the manner that such agency interprets its applicable charter, the procedures of the agency thereunder, and the nature of the industries affected by such agency. Only in this way -- by formulating reforms which are tailored to the wide variety of specific circumstances -- can effective regulatory reform be achieved.

Accordingly, we applaud this effort by Congress to review the Public Utility Holding Company Act of 1935 (the Act).[1] We believe that the time has come to recognize that the economic, legal, and regulatory structures that existed in the late 1920's and early 1930's -- and which led to adoption of the Act as a corrective measure -- are no longer applicable. The Act, as administered by the Securities and Exchange Commission (SEC) during the first twenty years after its passage, corrected the unsound conditions that existed; since that time, the function of the SEC has been mostly administrative housekeeping. Indeed, the SEC has unanimously endorsed repeal of the Act as no longer necessary in the public interest.

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[1] 15 U.S.C. §79.

A.G.A. member companies are affected in different ways by the Act. Three of our nearly 300 member companies[2] remain registered under the Act. On the other hand, approximately 50 of our member companies are holding companies which operate under an exemption from the Act. The remaining member companies -- which account for a majority of the A.G.A. membership -- are not covered by the Act, but some of the distribution companies would like to change to a holding company corporate structure and choose not to do so for fear of falling under the Act. In this latter case, a definite "opportunity cost" is imposed.

We heartily agree with Senators Alfonse D'Amato (R-NY) and Bennett Johnson (D-LA) that the Act is outdated. It must now be reexamined in the context of today's business and regulatory conditions. There are many reasons why the utility industry should not be required to operate under the regulatory burdens of an Act that was designed to deal with the circumstances of 1935, not 1983. A.G.A. appreciates the opportunity to present our views on these issues.

Repeal of the Act and the Need for Meaningful Regulatory Reform

A.G.A. views the Act as one additional overlay of unnecessary federal regulation that is hampering the ability of the natural gas industry to take its proper place in providing a greater part of this nation's energy mix. We view our support of repeal of the

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[2] Columbia Gas Systems, Inc., Consolidated Natural Gas Company, and National Fuel Gas Company.

Act as part of our industry's overall desire to streamline the regulatory process, thereby enhancing our ability to obtain adequate gas supplies and provide adequate utility service reliably and efficiently. A.G.A. has taken a strong role in encouraging Congress to adopt responsible regulatory reform legislation. We have also supported the Administration in its efforts to enforce its own initiative for regulatory reform through implementation of Executive Order 12291.[3] Finally, A.G.A. has taken an active role in previous and ongoing congressional efforts to streamline the permit process for priority energy projects in the form of "fast track" licensing proposals.

We would stress that in order to simplify and make more effective the regulation of the utility function of a gas company, a holding company structure is ideal. Under existing laws and regulations, regulatory agencies (federal and state) have ample powers to investigate -- and, if necessary, control for the benefit of utility consumers -- any and all transactions between the utility subsidiary and the affiliated companies in the system. For years the Federal Energy Regulatory Commission (FERC) has had no problems in regulating interstate pipelines on a "stand alone" basis. The same condition has also been the rule in many states where regulated gas utility holding companies operate. These instances demonstrate that the Act is not necessary -- as alleged by some -- to protect the consumer of utility services.

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[3] Executive Order No. 12291, 46 Fed. Reg. 13193 (February 19, 1981).

Regulatory delays and uncertainties can hinder the gas industry's ability to attract the capital needed to meet supply needs and to perform related system maintenance and construction. Overregulation at the federal and state levels will make it extremely difficult for this industry to obtain the new capital necessary to meet these investment requirements. The Act operates to impede or prevent registered and exempt holding companies from pursuing these kinds of necessary corporate strategies. In addition, it also deters other gas utilities from adopting a holding company structure which may be essential for pursuing --efficiently and profitably -- such activities.

There are three main reasons gas utilities seek to diversify:

(1) Preserve and expand gas markets -- By merchandising gas appliances and entering into marketing projects such as jointly-owned user/utility cogeneration facilities, low Btu on-site gasification facilities, or natural gas powered vehicles, gas distribution companies can market their gas more effectively.

(2) Secure present and future gas supplies -- Gas utilities increased their efforts in energy exploration and production, coal gasification and other supply projects during the 1970's when the estimates of future gas supplies were less optimistic. These operations have proven quite successful in helping to alleviate gas supply problems.

(3) Improve financial stability -- A.G.A. member companies strongly believe that diversification is needed to enhance their financial strength. Diversification helps counter the effects of business seasonality and regulatory lag by stabilizing a company's

profits. It can help maintain or expand gas markets, thereby enhancing utility operations. Financially stronger gas companies are more capable of providing gas service to their customers. Diversification also allows companies to expand into areas that have a growth potential that is not always available in the utility business. Improved financial stability and strength should lower the company's cost of capital, thereby saving money for gas consumers.

Indeed, the results of a recent A.G.A. study (Attachment 1) indicate that ". . . investors pay higher prices for the stock of, and require lower yields for debt issued by, more diversified gas utilities. This means that the cost of capital for those companies is lower, . . .".[4] To determine this relationship, companies' market-to-book ratios were plotted against their degree of diversification (defined as their percentage of assets dedicated to non-utility activities) using 1981 data. Regression analysis showed there was a very strong positive correlation between distribution company diversification and market-to-book ratio (i.e., as diversification increased, so did the market-to-book ratio). An even stronger correlation exists for those distribution companies regulated by "above average" and "average" state utility commissions (as determined by financial analysts' periodic assessments).

When bond ratings and average diversification measures were compared, investment surveys generally rated bond issues of more diversified companies as being of better quality than those of less diversified companies. A consistent pattern for distribution companies emerged: the higher the average diversification measure, the higher the bond rating.

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[4] Energy Analysis: Diversification and Natural Gas Utilities' Cost of Capital, American Gas Association, Arlington, Virginia (1982-17; November 9, 1982).

The financial markets have become much more diverse -- and the types of financing of new facilities and projects have become more sophisticated -- than when the Act was passed. The regulated utility competes for capital in the market with all enterprises (both regulated and non-regulated), and thus, in order for the company to attract capital it must provide an investor the expectation of earning a return comparable with that available from other investment alternatives (depending upon relative degrees of risk). The return required by investors is related to the degree of risk in the investment.

A financial analysis released this month by the A.G.A. (Attachment 2) analyzes the changes in investment risk for the regulated natural gas industry.[5] The study points out that in "recent years a number of factors have been considered as generally responsible for increased risk in the gas industry. These include rising gas costs, inflation, fluctuating interest rates, increased competition, and regulatory conditions." Total investment risk for companies primarily engaged in the distribution of natural gas has increased both absolutely and relative to other industries during the past 10 years. "Financial risk as measured by debt/equity ratios declined somewhat on an absolute basis between 1972-1976 and 1977-1981; however, on a relative basis, in 1982, distribution companies exhibited a greater degree of leverage (and, therefore greater financial risk) than 81.3 percent of industries...."

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[5] Financial Analysis: The Changing Nature of Investment Risk for the Natural Gas Industry, American Gas Association, Arlington, Virginia (FA 83-3, June 1983).

This conclusion contradicts the generally held assumption that the regulated natural gas companies are of relatively low risk. While that may have been true in the past, it is not so now. As the study points out, "[f]ailure of those maintaining oversight of the earnings of the regulated gas industries to acknowledge the increased risk will result in greater difficulty in attracting capital at a competitive and reasonable cost. Inability to attract capital on comparable terms with other industries . . . will result, in the long run, in higher rates to the consumer." Thus, contrary to the claims of some, diversification will assist in lowering -- not raising --the risk of investment in gas utility stock.

In addition, while the SEC has not prevented companies which are not subject to the Act from using the new financial vehicles available, the Act limits the ability of public utility holding companies to do so. Moreover, as the costs of major gas supply projects escalate, many companies find it necessary to engage in joint ventures in order to spread the risk and to obtain financing. However, many enterprises are very concerned about having companies covered by the Act as joint venture partners, since companies not under the Act fear becoming subject to it by virtue of this relationship. We believe the very presence of the Act, and its possible impact on financing, is not in the long term interests of the American consumer.

In our April 27, 1982 testimony before this Subcommittee, the A.G.A. witness explained in great detail additional reasons why repeal of the Act should be accomplished. Rather than repeat the points raised in our earlier testimony, we simply emphasize that the Act is not necessary for protection of the public interest. On the contrary, the Act is duplicative of other federal laws; the Act requires unnecessary and costly paperwork; and the Act places registered gas holding companies at a competitive disadvantage when trying to engage in activities that will benefit the gas consumer through improved supply security, adequate maintenance or even reduction of the company's financial risks.

Repeal of the Act would provide important relief for the regulated natural gas industry. Diversification of various types of activities -- some closely related and others less closely related to the successful marketing of gas -- is important for the financial health of the gas industry. In some cases, as the industry becomes riskier and more competitive in future years, diversification could even make the difference between insolvency and fiscal survival for some companies.

Conclusion

For the reasons discussed above, we urge this Subcommittee to support full repeal of the Public Utility Holding Company Act of 1935 rather than simply amend it. Our recommendation is consistent with that of the SEC. Thank you for this opportunity to present our views to the Subcommittee on this important issue.

6/28/83

[redacted]

ATTACHMENT 1

ENERGY ANALYSIS

AGA
American Gas
Association

Policy Evaluation & Analysis Group
American Gas Association
1515 Wilson Boulevard
Arlington, VA 22209
(703) 841-8400

1982-17 November 9, 1982

DIVERSIFICATION AND NATURAL GAS UTILITIES' COST OF CAPITAL

A. Introduction

Two factors have recently brought attention to the subject of diversification of investor-owned energy utilities. First, Congress is considering amending or repealing the Public Utility Holding Company Act of 1935 which limits utility diversification in some instances. Second, an increasing number of utilities are diversifying into ventures other than their primary line of business in an attempt to enhance their ability to serve customers while also improving their financial position. For example, some gas utilities have expanded their operations into gas exploration and production to insure future supply, while others have begun to market gas appliances and conservation services to increase the efficiency with which gas is utilized.

The rise in diversification activity among electric and gas utilities has caused concern among some regulators who question the benefits from diversification and worry about its potential effect on ratepayers. The National Association of Regulatory Utility Commissioners' draft report of the Ad Hoc Committee on Utility Diversification states that "...risk to the ratepayers does exist. For example, substantial losses in diversified ventures could lower a utility's market-to-book ratio and affect its bond rating. Both of these responses could increase the cost of capital for the utility."[1] This assertion has been directed at both gas and electric utilities, although supportive work to date has focused almost exclusively on electric companies. According to financial theory, well-managed diversification can be a means of reducing risk to the investor. With lower risk, the investor requires less return, and thus the cost of capital of the company drops.

The purpose of this analysis is to examine the relationship between diversification and the cost of capital of natural gas distribution and transmission companies.

B. Executive Summary

The results of this analysis show that investors pay higher prices for the stock of, and require lower yields for debt issued by, more diversified gas utilities. This means that the cost of capital for those companies is lower, which may translate into lower rates for gas utility customers. The analysis does not *prove* that

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this benefit to the consumer is the direct result of diversification. It does indicate, however, a relationship between extent of diversification and the cost of capital. Further, the benefit from diversification to gas utility customers is necessarily indirect through the utility's cost of capital -- regulated activities stand apart from non-regulated activities, and any profits or losses from diversified activities do not mix with utility earnings.

To determine the success of diversification in lowering the cost of capital for a gas utility, two indicators -- market-to-book ratio (stock market price of common stock divided by the equity of one share of stock in the company's assets; see Glossary of Terms attached) and bond rating -- were compared to a measure of diversification for each of 30 distribution and 20 transmission gas companies.

Market-To-Book Ratio Analysis

The distribution and transmission companies' market-to-book ratios were plotted against their degree of diversification (defined as their percentage of assets dedicated to non-utility activities) using 1981 data. Regression analysis, which mathematically determines whether a statistical relationship exists between the different variables (it does not prove, however, a cause and effect relationship), showed:

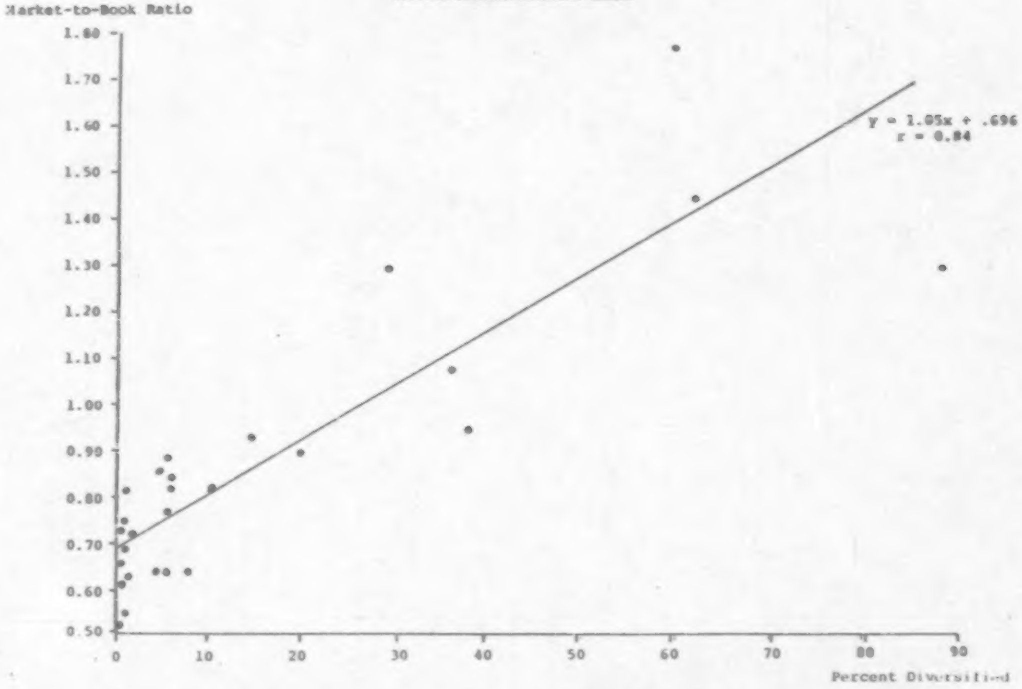
- There is a very strong positive correlation (correlation coefficient 0.84) and a positive slope (slope = 1.05) between distribution company diversification and market-to-book ratio (see Exhibit 1). That is, as diversification increases, the higher is the market-to-book ratio. (The correlation coefficient measures the strength of a relationship between two variables; the closer the measure is to 1.0, the stronger the positive relationship. The slope measures the change in the predicted or dependent variable, e.g., market to book ratio, as the independent variable, e.g., diversification measure, changes. A slope close to 1.0 indicates that the dependent variable changes similarly to the independent variable.)

- An even stronger correlation exists for those distribution companies regulated by (according to periodic assessments by financial analysts) "above average" state utility commissions (0.99 correlation coefficient) and "average" commissions (0.90 correlation coefficient).

- The correlation between market-to-book ratio and degree of diversification for pipeline companies is somewhat less (0.62 correlation coefficient), but the slope is higher (slope = 1.13), than for distribution companies. These statistics indicate that a positive relationship exists (see Exhibit 2).

Exhibit 1

DIVERSIFICATION AND MARKET-TO-BOOK RATIO GAS DISTRIBUTION COMPANIES

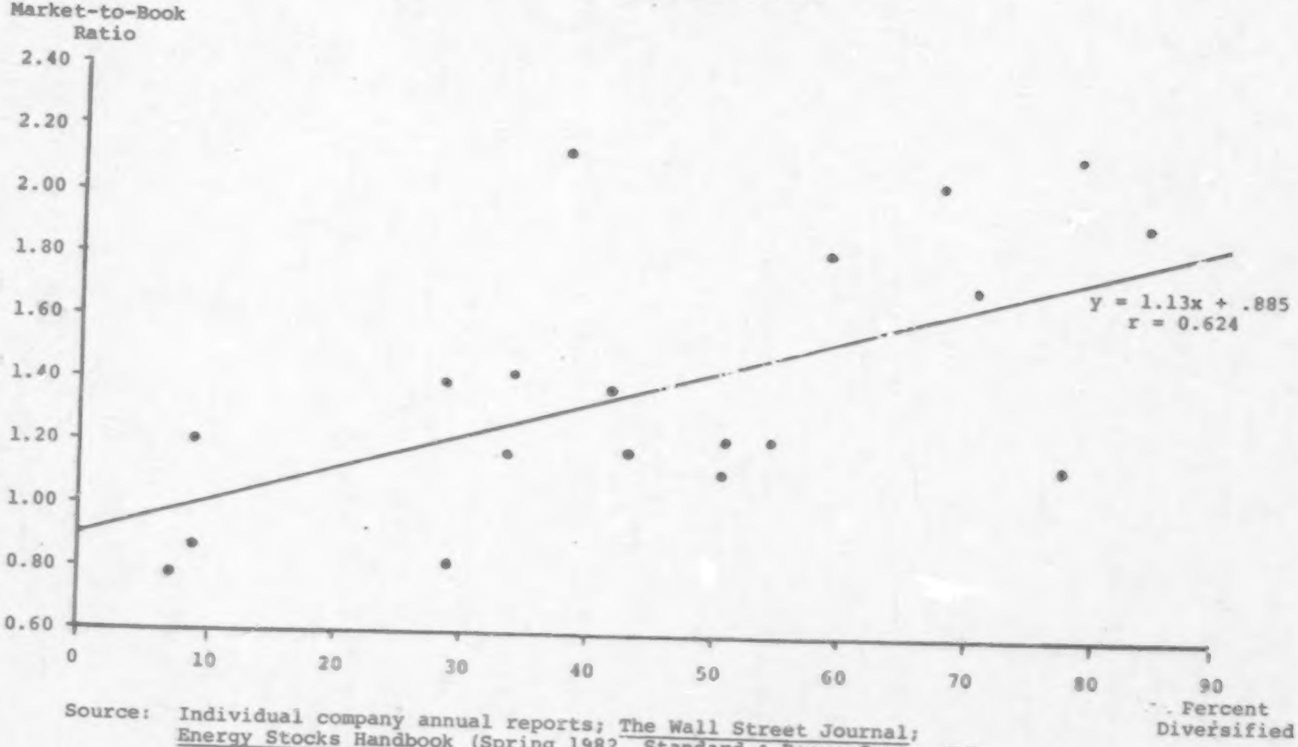


Source: Individual company annual reports; The Wall Stret Journal; Energy Stocks Handbook (Spring 1982, Standard & Poors Corp., NY); and confidential A.G.A. survey.

Note: A positive and statistically valid correlation exists even when only those companies less than 10 percent diversified are considered.

Exhibit 2

DIVERSIFICATION AND MARKET-TO-BOOK RATIO GAS TRANSMISSION COMPANIES



Source: Individual company annual reports; The Wall Street Journal; Energy Stocks Handbook (Spring 1982, Standard & Poors Corp., NY).

Bond Rating Analysis

When bond ratings and average diversification measures were compared, investment surveys generally rated bond issues of more diversified companies as being of better quality than those of less diversified companies. Both distribution and transmission companies showed a consistent pattern: the higher the average diversification measure, the higher the bond rating (see Exhibit 3). Higher bond ratings mean lower interest costs, which can lead to lower rates for utility customers. (This is true only when the debt/equity ratio remains relatively constant. While some analysts assume the percent of equity may increase as diversification increases -- which would increase the overall cost of capital -- no statistically significant relationship could be detected between percent equity and degree of diversification. See Appendix.)

C. Background

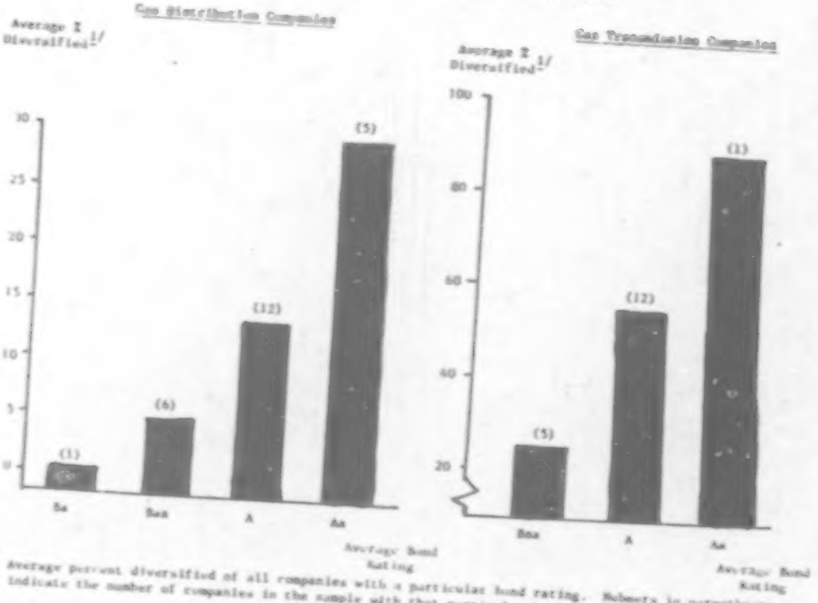
Natural gas transmission and distribution companies have a long history of diversification experience. Although some gas companies were involved in non-regulated businesses in the early part of the century, most distribution and pipeline company diversification has occurred over the past twenty-five years. Since 1960, the contribution of gas transmission revenues to total revenues of pipeline companies in the Moody's Natural Gas Transmission Industry Index has fallen from 80 percent to 50 percent.[2/] For pipeline companies, the major portion of the investment in non-regulated businesses occurred in the 1960s. These early investments were primarily made in gas-related fields, such as oil and gas exploration and production, gas storage, liquefied petroleum gas plants, and gas appliances. More recently, pipeline investments have become less concentrated, with the acquisition or formation of other industries. However, gas-related industries continued to receive the heaviest level of the diversified investment, particularly for those investments that could increase the future reserves of natural gas.

Distribution companies have begun to invest in non-regulated businesses mainly within the past ten years, and their average investment in the diversified businesses has not been as intensive as has that of transmission companies. On average, non-utility businesses contributed less than 13 percent of the total revenues of distribution companies responding to an A.G.A. survey of member companies. As with the transmission companies, most of the distribution company diversification has been in gas-related areas. Many distribution companies are involved with selling gas appliances, which can maintain or expand gas demand; some are involved in gas exploration and production so as to improve their future supply situation.

Gas utilities diversify for several reasons. Generally, the reasons fall into three categories:

Exhibit 3

AVERAGE DIVERSIFICATION AND BOND RATINGS OF GAS UTILITIES



Gas Distribution Companies

Gas Transmission Companies

1/ Average percent diversified of all companies with a particular bond rating. Numbers in parentheses indicate the number of companies in the sample with that particular bond rating.

Source: Moody's Investor Service, Moody's Public Utility Manual; Selected company annual reports; and confidential A.G.A. survey.

Note: Top of bar indicates percent diversified; e.g., the one company with a Ba rating is 0 percent diversified.

- Preserve and expand gas markets -- By merchandising gas appliances and encouraging efficient gas use through subsidiaries, gas distribution companies can market their gas more effectively. One distribution company noted that since the company offers such services as installing furnaces and merchandising appliances, their gas customers enjoy the benefits of a total service package;

- Secure present and future gas supplies -- Gas utilities increased their efforts in energy exploration and production, coal gasification, and liquid natural gas during the 1970s when the estimates of future gas supplies were less optimistic than today. Many companies have had success with their exploration and production subsidiaries, and they have thus helped to alleviate the supply problems; and,

- Improve financial stability -- Most of the member companies that commented in the A.G.A. survey stated that diversification is needed to enhance their financial strength. Diversification helps counter the effects of business seasonality and regulatory lag, and it can help maintain or expand gas markets thereby enhancing utility operations. Diversification also allows companies to expand into areas that have a growth potential that is not always available in the utility business. Improved financial stability and strength should lower the company's cost of capital. Also, financially stronger gas companies are more capable of providing gas service to their customers.

Economic theory supports these firms' supposition that diversification enhances a company's financial strength. The gas utility industry's present situation makes such benefits from diversification very attractive. Diversifying can stabilize a company's profits, particularly for those companies with cyclical earnings.3/ In addition, some utilities are located in areas that are suffering from saturated markets and falling demand for gas, which restricts their growth potential. By investing in other lines of business that help to expand gas markets, gas utilities can improve their growth outlook.

Stabilized earnings, improved business growth outlook, and lessened chance of business decline serve to reduce risk and help to maintain the company's attractiveness to investors. Investors demand a greater return to compensate for greater risk, so reducing risk should lower the required return of investors and thus should lower the company's cost of capital.

Proponents of diversification cite other benefits. Business growth attracts and keeps capable management and staff. Also, new business ventures can translate into added job opportunities for a community.3/ Finally, by diversifying a company may be able to take advantage of investment opportunities not available to investors, such as joint ventures with other companies.3/

Some regulators are wary of utility diversification for fear that such activity may not be in the best interests of ratepayers. They have cited potential abuses, which could include:

- Losses in the diversified activity being charged to utility customers;
- Improper allocation of utility/non-utility costs; and,
- Inappropriate transfer pricing practices for sales of diversified company products to the utility.[6]

Respondents to the A.G.A. survey agreed that regulators should ensure that utility operations and property are treated separately when making rate or other regulatory decisions, and that regulators should also ensure that cost allocations are proper so as to protect utility customers. However, they noted that should regulators try to become involved with the operations of the diversified activities, either directly or indirectly, the benefits of diversification would not be realized.

D. Methodology

Two indicators were selected as measures of a gas utility's cost of capital: market-to-book ratio and bond rating. The market-to-book ratio compares the stock market price of a company's common share to the equity of one share of stock in the company's assets (calculated by dividing common equity by the number of common shares outstanding).

Bond ratings, determined by independent investment companies, assess the risk of a company's issue of debt. If a debt issue is rated highly, it means that the issuing company is determined to be in better financial condition and the risk of default is lower than a lesser-rated company's debt issue. With lower risk, investors require less return, and the issue sells at a relatively lower yield and carries a smaller interest cost. When assigning a bond rating, investment companies examine many aspects of the company to determine financial integrity. For the gas utility, regulatory environment, gas supplies, market area, present financial strength, construction budget, and capitalization structure are just some of the factors that influence their bond rating designation. Thus no one aspect of a utility determines its bond rating.

For this analysis, distribution companies were considered separately from transmission companies because each of these groups face different regulatory environments and perform different functions. Also, no electric utilities or combination gas-electric utilities were included in the sample since their financial characteristics are significantly different from strict gas utilities.

The samples of companies examined for this analysis were drawn from two sources. The distribution company sample consists of a subset of those member companies that responded to a 1981

A.G.A. questionnaire on each company's experience with diversification. Over 40 distribution companies responded but many of them were not included in the sample because:

- Some respondents were municipal utilities and [illegible] common stock outstanding;
- Some companies' bonds are not rated; and,
- Necessary 1981 data could not be obtained for some companies.

Of the total respondents, 30 gas distribution companies were included in the sample. These companies indicated the percentage of their total assets that are devoted to non-utility activities, and that figure served as the measure for diversification.

The pipeline company sample consists of 20 A.G.A. member transmission companies. Only those companies having rated bond issues and/or publicly traded common equity were included in this analysis. Each pipeline's degree of diversification was calculated by dividing its non-utility assets by its total assets as reported in its 1981 annual report.

The market price of each company in the sample was the average of the highest and lowest stock prices in 1981 taken from either The Wall Street Journal or the company's annual report. The book value for each company was calculated by dividing common equity by total number of shares outstanding as reported in its 1981 annual report. The bond rating assigned to each company was taken from the 1981 Moody's Public Utility Manual. (The explanation of this rating system appears in Exhibit 4.)

To determine if diversification affects a company's cost of equity, a regression analysis was performed. Regression analysis mathematically estimates the statistical relationship between different variables -- in this case each company's degree of diversification and market-to-book ratio. After collecting the data for the sample companies' variables, the equation of a line that best fits the data points of the sample is calculated according to the "least squares" criterion. (The "least squares" method employs a mathematical formula that estimates a best fitting line by minimizing the sum of the squared errors). By using the equation of the resulting line, a company's market-to-book ratio can be estimated, based on its degree of diversification.

The slope of the best fitting line indicates how the dependent or predicted variable (e.g., market-to-book ratio) changes as the independent variable (e.g., diversification measure) changes. A slope of 0.0 indicates the dependent variable does not change as the independent variable changes. A slope of 1.0 indicates that the dependent variable changes to the same degree as does the independent variable. The correlation coefficient measures the strength of a relationship between two variables. The correlation

Exhibit 4

AVERAGE YIELDS OF PUBLIC UTILITY BONDS

Moody's Bond Rating	August, 1981 Average Yield
Aaa	15.41
Aa	16.14
A	16.58
Baa	17.19
Ba	N/A

Note: The rating system used by Moody's ranges from least investment risk (highest investment quality-Aaa) to greatest investment risk (lowest investment quality-C). No companies in the sample had ratings lower than Ba. In addition, Moody's has recently refined its rating system by including numerical modifiers to bond ratings ranging from Aa to B. A rating of 1 indicates the issue is considered in the upper end of its rating, a 2 indicates the middle, and a 3 indicates the lower end.

Source: Moody's Public Utility Manual, 1981, Moody's Public Utility News Reports May 21, 1982 (Moody's Investor Service, New York, NY).

coefficient is determined by calculating the absolute value of the differences between the actual data points to their estimated value according to the line derived by the "least squares" criterion. These differences are used to calculate the correlation coefficient. The closer the correlation coefficient, *r*, is to 1.0, the stronger the positive relationship is between the two variables. To calculate the significance or confidence level in the regression analysis, the Student's *t* test was employed. The Student's *t* test determines whether the small sample used in the regression analysis is representative of the larger population from which the sample was drawn. This is calculated by mathematically comparing the correlation coefficient and the number of data points in the sample. Usually, it is considered that any *t* test with a confidence level of over 95 percent is significant, i.e., that the sample does represent the total population accurately.[7]

This analysis did not employ multiple regression techniques that could better determine the relationship between market-to-book ratio and degree of diversification by factoring out the impact of other variables (such as earnings growth) on market-to-book ratio. This analysis is meant to be a first step; more sophisticated statistical techniques will be employed in follow-up work.

Regression analysis was not appropriate to test for a relationship between bond ratings and degree of diversification since bond ratings do not have numerical values. Instead, the companies were grouped by bond rating, and each group's average diversification measure was compared to its corresponding bond rating. Not all of the gas utilities in the market-to-book analyses were included in the bond rating analyses, since some companies did not have bonds rated by Moody's.

E. Discussion of Results

Exhibit 1 shows the linear relationship between degree of diversification and stock market performance for 27 natural gas distribution companies. As the figure shows, there is a strong correlation between the two variables; the correlation coefficient of 0.84 is close to 1.0. The slope of 1.05 indicates that a change in the diversification measure leads to a similar change in the predicted market-to-book ratio. The Student's *t* tests places a confidence level of significance of over 99 percent for both measures, which indicate that the tests are valid and that the sample examined is representative of all the companies. These results support the theory that investors place a premium on stock of more diversified companies.

In an earlier energy analysis[8], it was shown that regulatory agency performance also affects the financial standing of gas distribution companies. In an attempt to isolate that factor to judge diversification's effect on stock prices more accurately, another test was employed. The distribution companies were broken into three groups: those with Public Utility Commissions

(PUCs) rated "above average" by financial analysts; those with PUCs rated "average"; and those with PUCs rated "below average".[9/] The results of this breakdown (Exhibit 5) show that the relationship is stronger between market-to-book ratios and diversification for those companies with "average" or "above average" PUCs. The correlation coefficient of 0.99 for companies with "above average" regulators is almost perfect, with a significance level above 99 percent. The companies with an "average" regulatory environment have a correlation coefficient of 0.90, with a similar confidence level of 99 percent. The relationship for those companies with a "below average" regulatory environment is not as strong and, more importantly, it is not as statistically significant. However, all categories do show a positive correlation between stock performance and diversification, and further show that a relationship exists between diversification and the market price of a gas distribution utility's stock.

Exhibit 2 shows that the correlation for natural gas transmission companies is not as strong as that of distribution utilities (0.62 correlation coefficient), but the slope is higher (slope equals 1.13). The larger slope indicates that the predicted value of the market-to-book ratio changes more for transmission companies than distribution companies given a similar change in diversification measure for each type of utility. Thus, a positive relationship does exist with a confidence level of over 99 percent for both measures. Most of the pipeline companies are over 30 percent diversified, and very few have a market-to-book ratio under one. A breakdown of pipelines by regulatory environment was unnecessary since they all fall under federal jurisdiction.

A positive relationship also exists between gas utility bond ratings and diversification. Exhibit 6 shows the average diversification of the utility companies in a certain bond rating category for both distribution and transmission utilities. For pipelines, the higher the average diversification level, the better the rating assigned to their bond issues. For distribution companies the trend is not as exact but, on the whole, more diversified companies get better bond ratings. It must be kept in mind that the assignment of bond ratings depends on many factors besides diversification, and that some non-diversified utilities have high bond ratings. However, these data seem to indicate that investment services feel that more diversified utilities have lower investment risk.

F. Implications of Results

The results of this analysis show that diversification activities of natural gas utilities have, on average, benefited both investors and, indirectly, ratepayers. Stockholders benefit since market-to-book ratios improve with the degree of diversification of a utility. Improved market-to-book ratios help prevent dilution of stockholders' investments.

Exhibit 5

CORRELATION OF DIVERSIFICATION AND STOCK PERFORMANCE OF GAS DISTRIBUTION COMPANIES BY REGULATORY ENVIRONMENT

Regulatory Environment	Correlation Coefficient	Significance Level
Above Average	0.99	99%
Average	0.90	99%
Below Average	0.80	80%
Total Sample	0.84	99%

Source: Electrical World, November, 1980; Individual company 1981 annual reports; The Wall Street Journal; Energy Stocks Handbook (Spring, 1982, Standard & Poors Corp., New York).

Exhibit 6

GAS UTILITY BOND RATINGS AND AVERAGE DIVERSIFICATION MEASURE

Moody's Bond Rating[1]	Percent Diversified[2]	
	Distribution Companies	Transmission Companies
Aa1	40.0 (1)[3]	- (0)[4]
Aa2	34.0 (3)	86.8 (1)
Aa3	0.2 (1)	- (0)
A1	20.9 (4)	61.5 (4)
A2	15.2 (5)	49.2 (6)
A3	3.7 (3)	41.7 (2)
Baa1	- (0)	39.0 (1)
Baa2	3.7 (4)	26.6 (4)
Baa3	7.0 (2)	- (0)
Ba1	- (0)	- (0)
Ba2	- (0)	- (0)
Ba3	0.0 (1)	- (0)

---

[1] Moody's Investor Service.

[2] Percent of assets devoted to non-gas distribution or transmission -- average of sample.

[3] Numbers in parentheses indicate the number of companies with that bond rating in sample.

[4] No companies in sample have that bond rating.

Ratepayers indirectly benefit because diversification keeps the cost of capital of gas utilities down. First, more diversified companies, on average, receive higher bond ratings, which translates into lower interest costs. Since ratepayers pay interest costs, diversification helps to keep rates down. Second, because investors place a premium on diversified gas utilities, these companies have more flexibility in the capital markets. With more freedom to plan their financing strategy, companies can use their capital more efficiently and keep their average cost of capital down.

A factor which also influences capital cost is the debt/equity ratio of a gas utility. As regards diversification, no evidence was found that more diversified companies have higher equity ratios relative to debt, which could raise the overall cost of capital (see Appendix).

These conclusions are drawn with respect to gas utilities only; electric and combination gas-electric utilities were not included in this analysis. Electric utilities are not as diversified when compared to gas utilities, although electrics are beginning to show more interest in diversification. Natural gas utilities, on the other hand, have a long history of successful diversification experience[10] due to three basic factors:

- Natural gas utilities started to diversify when they had strong cash flows that were available for investments in non-regulated activities;[11]
- Usually, natural gas utilities invested in areas closely related to the gas industry, where the utilities' management expertise could be exploited. The timing of such investment proved to be good, especially for oil and gas exploration;[12] and,
- Natural gas utilities have followed a program of steady diversification to reach their present investment levels.[13]

Overall, natural gas utility diversification has been successful in improving the financial strength of the companies involved to the benefit of both the stockholder and, indirectly, the ratepayer.

The methodology of this analysis was purposely kept relatively simple since this analysis is meant as a first step in studying diversification. More intricate methodology, including multivariate regression analysis, will be employed in follow-up work.

NOTE: Diversified activities do not directly benefit ratepayers. Earnings and losses from the diversified activity do not impact on ratepayers directly, since these activities are unregulated and stand alone from the utility. Ratepayers ultimately benefit through, among other things, lower capital costs.

GLOSSARY OF TERMS

Bond Rating - A measure of the legality and the financial and economic position of a company's debt issue, determined by independent investor services based on a set of several standards. A higher rated bond usually has less default risk.

Correlation - A mutual or reciprocal relation between variables.

Correlation Coefficient - A measure of the strength of a relationship between variables. The closer the coefficient is to 1.0, the stronger the positive relationship is between the variables.

Cost of Capital - The price a company must pay lenders and investors for the use of the lenders' and investors' money.

Dependent (or Predicted) Variable - in this analysis, the hypothetical value for an estimated market-to-book ratio with a given diversification measure, based on the perceived relationship determined by the regression analysis of real world data.

Diversification - For this analysis, investment in any non-utility business venture, as measured by dividing non-utility assets by the company's total assets.

Independent Variable - in this analysis, the diversification measure, which theoretically does not change as a result of a change in the market-to-book ratio (dependent variable).

Least Squares Criterion - A mathematical method of determining the equation of a line that best fits or estimates the relationship of different variables when plotted on a graph.

Market-to-Book Ratio - The market price of a company's share of stock (the price investors are willing to pay for the stock) divided by its book value (the net worth of a corporation less the par value of preferred stock outstanding, divided by the number of common shares outstanding).

Regression Analysis - A mathematical estimation of the statistical relationships between variables, usually employing the least squares criterion.

Return - The total annual income to an investor or lender as a percentage of a perosn's investments.

Slope - indicates the change in the dependent variable as the independent variable changes. A slope of 1.0 indicates that the two variables change in a similar fashion.

Statistical Confidence Level (or *t* statistic) - A measure, expressed in percentage terms, that numerically estimates the validity of a statistical analysis. The closer the measure is to 100 percent, the more valid is the test.

Student's *t* Test - A method used to determine if the sample used in a statistical analysis is truly representative of the larger population from which the sample is drawn. In this analysis, it is used to determine whether the gas utilities studied represent the behavior of the entire gas utility industry.

Yield - The total annual income to an investor or lender as a percentage of the investment.

FOOTNOTES

1. National Association of Regulatory Utility Commissioners, Draft Report of the Ad Hoc Committee on Utility Diversification, (Washington, DC: April 7, 1982) p. 12.

2. Moody's Public Utility Manual, 1960-1981. The companies in the index are: El Paso Natural Gas Co., Northern Natural Gas Co., SONAT Inc., Tenneco Inc., Texas Eastern Corp., Transco Companies Inc., United Energy Resources Inc., and Panhandle Eastern Co.

3. Cabot Consulting Group, Diversification in the Utility Industry (Washington, DC: March, 1982) p. 29.

4. American Gas Association, "The American Gas Association's comments on the April 7 Draft Report of the Ad Hoc Committee on Utility Diversification of the National Association of Regulatory Utility Commissioners" (Arlington, VA: April 30, 1982) p. 12.

5. Diversification in the Utility Industry Op. cit. p. 34.

6. Draft Report Op. cit. p. 7.

7. See William Mendenhall, Introduction to Probability and Statistics (Duxbury Press, North Scituate, MA, 1975).

8. American Gas Association, The Relationship Between State Regulatory Policy and Gas Utilities' Financial Standing, (Arlington, VA: September 4, 1981).

9. From Salomon Brothers' rankings of U.S. Public Utility Commissions in Electrical World, November, 1981. Those whith grades A or B were designated above average; C, average; and D or E, below average.

10. Diversification in the Utility Industry Op. cit. p. 63.

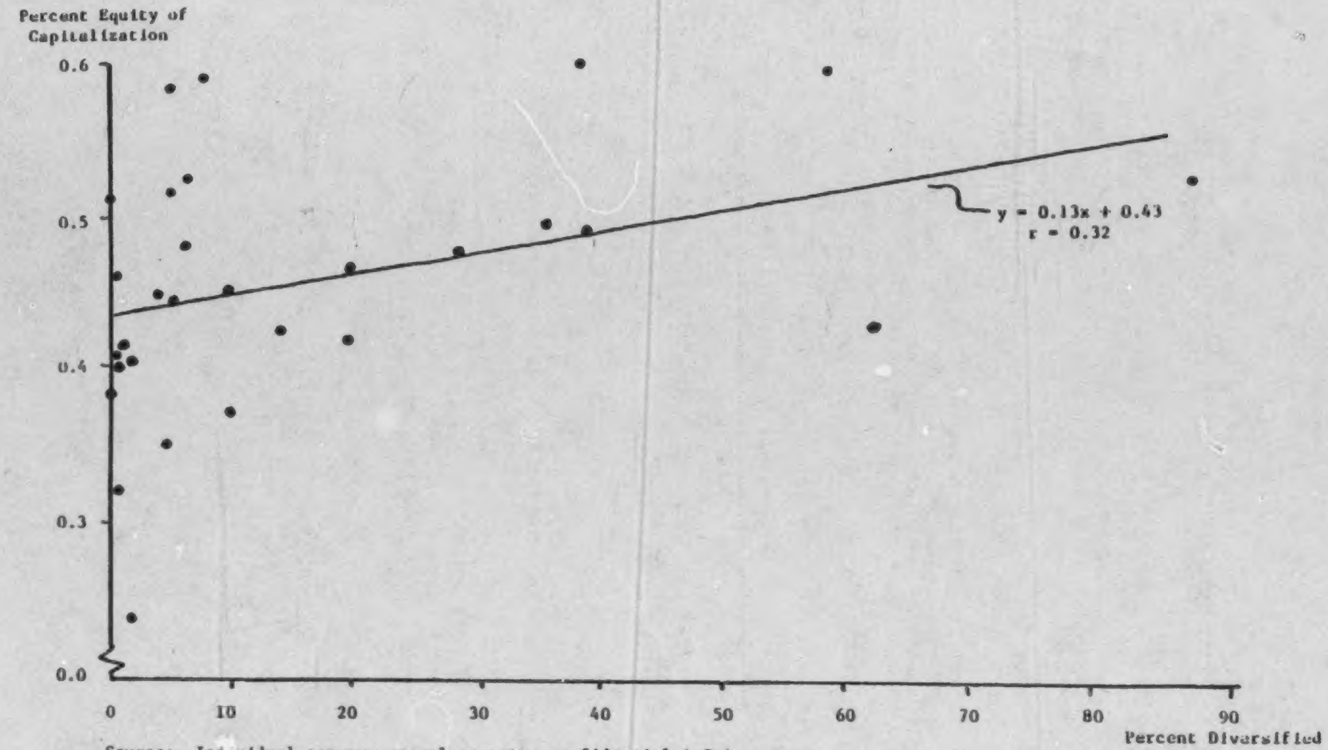
11. Eric R. Zausmer and Mitchell Kress, "Electric Utility Diversification: Strategic Considerations" Utility Management Perspectives (Fall, 1981, Booze, Allen, and Hamilton Inc.) p. 4.

12. Ibid., p. 4.

13. Draft Report Op. cit. p. 42.

Appendix

DIVERSIFICATION AND EQUITY PERCENTAGE OF CAPITALIZATION FOR GAS DISTRIBUTION COMPANIES



Source: Individual company annual reports; confidential A.G.A. survey.

ATTACHMENT 2

AGA
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June 1983

FA 83-3

THE CHANGING NATURE OF INVESTMENT RISK FOR THE NATURAL GAS INDUSTRY

A. Introduction

In evaluating the reasonableness of rate increases filed by investor-owned regulated entities, critical attention is paid by regulators to the firm's cost of capital. The regulated entity competes for capital in a market with all enterprises (both regulated and non-regulated), and thus, in order for the company to attract capital it must provide an investor the expectation of earning a return comparable with that available from other investment alternatives (depending upon relative degrees of risk).

It is axiomatic that the return required by investors is related to the degree of risk in the investment. Therefore, in setting an allowed rate of return for a regulated gas company, regulators must be necessarily concerned with the relative riskiness of the investment in relation to that of alternative investments. In many instances, particularly in the natural gas industry, the regulated company has been assumed to be of a relatively lower risk (in relation to nonregulated business) because it is considered to be a natural monopoly -- an entity not subject to the vagaries of competition.

In recent years a number of factors have been considered as generally responsible for increased risk in the gas industry. These include rising gas costs, inflation, fluctuating interest rates, increased competition, and regulatory conditions. This analysis examines the relative degree of investment risk for companies primarily engaged in the transmission and/or distribution of natural gas. While investors generally examine a variety of factors when making an investment decision, and rating agencies evaluate numerous criteria in determining the rating of a particular fixed income instrument, for purposes of this analysis, investment risk (consisting of both business and financial risk) is measured primarily in terms of volatility of earnings. Debt/equity ratios (degree of leverage) are also examined. Changes in the nature of risk over the 10-year period 1972-1981 are examined and comparisons of the relative degree of risk for regulated gas companies with that of many major industry groupings are developed.

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B. Executive Summary

- As a result of changing market conditions and industry cost structure, rising interest rates, inflation, and regulatory conditions, total investment risk for companies primarily engaged in the transmission and/or distribution of natural gas has increased both absolutely and relative to other industries during the past 10 years. Therefore, so that regulated gas companies may remain competitive in the capital markets, cost of capital determinations must reflect the changing nature of risk.

- On a relative basis, Table 1 details the change in investment risk (as measured by variability in earnings) for the regulated gas industries.

  - Whereas in the 1972-1976 period 3.8 percent of regulated and nonregulated industries exhibited less variability in return on total capital than the gas distribution industry, by the 1977-1981 period 28.3 percent exhibited less volatility.

  - Similarly, in the 1972-1976 period, 30.2 percent of industries exhibited less variability in earnings (as measured by return on total capital) than the gas transmission industry; however, by 1977-1981 the pipeline industry had greater variability (and therefore greater business risk) than 47.2 percent of industries.

  - In terms of variability in return on net worth, in the 1972-1976 period, 9.6 percent of industries exhibited less risk than distribution companies; however, by the 1977-1981 period the distribution industry's earnings reflected a greater degree of variability than 51.9 percent of industries.

  - The relative business risk of pipelines as measured by variability in return on net worth increased from being riskier than 13.5 percent of industries in the 1972-1976 period to 32.7 percent of industries in the 1977-1981 period.

- On an absolute basis, risk as measured by the variability in earnings in terms of return on net worth increased for both pipelines and distributors between 1972-1976 and 1977-1981.

- Financial risk as measured by debt/equity ratios declined somewhat on an absolute basis between 1972-1976 and 1977-1981; however, on a relative basis, in 1982, distribution companies exhibited a greater degree of leverage (and, therefore, greater financial risk) than 81.3 percent of industries while pipelines exhibited greater financial risk than 68.8 percent of industries.

C. Background

The earnings of all regulated companies, regardless of industry, are subject to evaluation under the same general legal principles. In the Bluefield Waterworks case, the Supreme Court stated:

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."[1] (emphasis added)

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[1] Bluefield Waterworks & Improvements Co. v. Public Service Commission of West Virginia, 262 U.S. 679, 692-695 (1923).

In the Hope Natural Gas decision, the Court stated:

> "The return to the equity owner shall be commensurate with returns on investments in other enterprises having corresponding risk. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[2] (emphasis added)

Inherent in both of these legal decisions is the concept of "comparability." That is, investors in regulated enterprises require a return on their investment comparable to that attainable from investments in other industries (or money market instruments). This is the implicit assumption of the capital attraction standard as enunciated in the legal principles - that the regulated entity must be able to attract capital so that it may function on a long-term basis. In order to attract the necessary capital, the company must be able to offer its investors a return equivalent to that available from alternative investments.

Underlying the concepts of comparability and capital attraction is the notion of investment risk. There is an axiom in economics and finance that investors in industries (or money market instruments) that exhibit a relatively higher degree of risk require a higher rate of return than do investors in opportunities exhibiting a relatively lower degree if risk. In general, investors are assumed to be risk-averse. In other words, for a given return level, investors prefer the investment with the least risk.

Risk, in the context of investment analysis, is present whenever there is a probability distribution of possible outcomes rather than a certain outcome. Normally, an investor is not sure what his return will be in an equity investment, but he can gain some knowledge of the probable return by examining the past behavior of the return received from the investment, the financial leverage of the firm, the performance of the firm and industry, and general appraisals of future growth.

Total investment risk consists of two interrelated components, business risk and financial risk. Financial risk can be estimated by examining the capital structure of the firm and hypothesizing that the greater the percentage of debt, and the more expensive it is, (i.e., the higher the embedded cost of debt) the more volatile is the return on equity. Traditionally, the view has been held that an equity investor is subject to more risk in a highly-leveraged company than he is in one employing a lesser degree of leverage. The reasons for this are twofold. First, a more leveraged company has a larger amount of fixed charges (i.e., interest payments), and if earnings decline, is more susceptible to financial problems. Hence, there is increased risk for the equity holder. Second, the firm does not have the contractual obligations with equity holders that it has with fixed income security holders, and consequently, should liquidation occur, the common equity holders are last in the priority of claims.

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[2] Federal Power Commission v. Hope Natural Gas Co. 320 U.S. 591, 603 (1944).

Business risk is measured in terms of fluctuations in earnings. Higher fluctuations in earnings are symptomatic of higher levels of risk to the investor. The tighter the distribution of possible outcomes (the less variation in earnings), the more likely the actual outcome will equal the expected outcome, and, therefore, the more certain is the return on the investment. Investors, therefore, will typically require a lower rate of return from a firm that has less variation in its earnings than they would from a firm with a more volatile earnings pattern.

Traditionally, the relative degrees of business and financial risk have been interrelated. That is, companies (industries) with a high degree of business risk (higher variability of earnings) would be expected to have a lesser degree of financial risk (a lower percentage of debt in the capital structure). Utilities (electric, gas, water, and telephone) traditionally have had relatively higher levels of debt in their capital structure than other industries,and consequently have had higher levels of financial risk, offset by lower levels of business risk.

D. Methodology

To determine levels of business risk, historical financial data on over 50 industries were developed from the Value Line Investment Survey. Similar data for the gas distribution and transmission industries were developed from A.G.A.'s Gas Facts. The assessment of business risk was conducted through an examination of variability in profitabily ratios. Profitability ratios for which data were derived are return on total capital and return on net worth. Return on total capital is defined as

$$\frac{\text{Net Income + (1- tax rate) Interest on Long-Term Debt}}{\text{Long-Term Debt + Net Worth (Less deferred taxes)}}$$

The return on total capital ratio is a principal measure of the economic performance of a firm, or industry, since it does not reflect distortions among industries that may occur as a result of differences in capital structures, and does reflect a relationship between income and the total capital (provided by all investors) used to generate that income.

Return on net worth is expressed as

$$\frac{\text{Net Income}}{\text{Net Worth}}$$

where net worth is considered to include all of the company's (industry's) assets less current liabilities, long-term debt, and all other noncurrent liabilities. Net worth can be considered as the sum of common and preferred stockholders' equity. The Value Line Investment Survey does not publish data on return on equity for all of its industry groupings, therefore, this standard profitability measure has not been evaluated in this analysis. However, as a general principle, return on net worth can be considered an adequate proxy for return on equity.

For each of these data series, information covering the period 1972-1981 was collected. Various statistical measures were used to examine the variability of the profitability data over each time period and among industry groupings.

The coefficient of variation was utilized to reflect the relative variation in both return on total capital and return on net worth. The coefficient of variation is a measure that expresses the size of the variation relative to the size of the quantity being measured. This measure reveals the degree of instability per percentage point of return. It reflects, therefore, a risk/return tradeoff. The coefficient of variation is calculated by expressing the standard deviation as a percent of the mean. As a measure of risk, a recent study found that investment bankers placed their highest level of confidence, importance, and significance on the coefficient of variation, in relation to other measures of risk.[3] The following is an example of the usefulness of the coefficient of variation:

1. The 10-year average rate of return on total capital for Industry A is 13 percent, with a standard deviation of 2.

2. The 10-year average rate of return on total capital for Industry B is 15 percent, but also with a standard deviation of 2.

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[3] P.R. Chandrasekaran and William P. Dukes, "Risk Variables Affecting Rate of Return of Public Utilities." Public Utilities Fortnightly, February 26, 1981, p. 34.

3. Since the coefficient of variation is the standard deviation as a percentage of the mean, the coefficient of variation for Industry A is 2/13 or .154 and for Industry B, it is 2/15 or .133. Thus, for the two industries, each of which has the same standard deviation, the industry with the lower rate of return has the higher coefficient of variation, which means that it would have a more difficult time attracting capital. Industry B, with the same level of volatility as Industry A, offers a higher return and, thus, has a lower coefficient of variation. Consequently, it will have a better opportunity for attracting capital.

The standard deviation and the variance were utilized as additional measures of variability in terms of return on net worth and return on total capital. The standard deviation measures the average amount by which a set of individual data varies in either direction from its mean. The variance, which was listed by investment bankers as second to the coefficient of variation as a measure of business risk, is calculated by squaring the standard deviation.

Data on the degree of leverage (debt/equity portions of the capital structure) for use in evaluating the level of financial risk were derived from Forbes in addition to Gas Facts.

E. Discussion of Results

There are various means of measuring the relative risk of a firm or industry. The regulated gas industry has faced relative risks in previous years in terms of supply shortages and high degrees of leverage. However, regulated gas companies have historically exhibited a relatively low degree of business risk (as measured solely by earnings volatility) in comparison with nonregulated industries. As Tables 2-5 (attached) indicate however, in recent years the earnings volatility of regulated gas companies has increased and consequently, the nature of risk faced by these companies has changed.

Tables 2 and 3 provide data on the variability in return on total capital for 53 industries during the 1972-1981 period. Variability in return on total capital is generally accepted as a measure of the total business risk of the enterprise. That is, it measures the total risk of the firm before taking into account the effects of leverage on the risks borne by the stockholders.

As Table 2 indicates, during 1972-1976 gas distribution companies ranked 51 out of 53 industries. Clearly, distribution companies were among the least risky industries (as measured by earnings volatility) surpassed only by the household products industry and the health care/hospital supplies industry. Thus, there has been a perception that regulated gas companies were among the least risky industries with stable earnings flows. In fact, in 1972-1976 over 94 percent of industries were riskier than the gas distribution industry. By examining the standard deviation and the variance, it can be seen that only the health care/hospital supplies industry was less risky during the period. However,comparing Tables 2 and 3 it can be seen that during 1977-1981 the coefficient of variation of gas distribution companies rose from .0374 to .0613, and since many other industries experienced less volatility in earnings during the period, gas distributors moved from 51st out of 53 industries to 38th out of 53. So that by the 1977-1981 period distribution companies were riskier than 28.3 percent of industries--including such cyclical industries as electrical equipment and machinery.

The increased risk of distribution companies is evidenced by the fact that of 53 industries, the variability in return on total capital declined for 40 groups between 1972-1976 and 1977-1981, with only 13 (24.5 percent) industries increasing - one of which was the gas distribution industry.

For the gas pipeline industry, the relative variability of earnings as measured by return on total capital declined slightly from the 1972-1976 period to the 1977-1981 period; however, the industry became noticeably riskier in relation to other industries over the two time periods. Whereas pipelines ranked 37th out of 53 industries in 1971-1976, by 1977-1981 the industry was 28th out of 53.

Tables 4 and 5 provide data on the return on net worth for 52 industries during the 1972-1981 period. In this analysis, return on net worth is used as a proxy for return on equity (ROE) since the Value Line Investment Survey does not provide ROE data for each of its industry groupings. As Table 4 indicates, using the coefficient of variation, natural gas distribution companies ranked 47th out of 52 industries during the 1972-1976 period. In other words, the variability of earnings for the industry, as measured by return on net worth, was so low that only five other industries had less variation. In terms of both their standard deviation and variance, only four industries had less variability than the gas distribution industry during the period.

However, as Table 5 indicates, the distribution industry's level of risk changed dramatically during the 1977-1981 period. The coefficient of variation increased from .0479 to .1000. During the five-year period (the most recent period for which full-year financial data are available), the distribution industry's ranking went from 47th out of 52 to 25th out of 52 In other words, during 1972-1976 only five other industries were less risky than the distribution industry, but during the 1977-1981 period, 27 other industries were less risky. In the earlier period the distribution industry was less risky than 89 percent of industries. During the most recent period, the industry was less risky than only 46 percent of industries. In fact, during 1977-1981 more than one-half of the industry groups surveyed were less risky than the distribution companies. Similar rankings are found when risk is measured by either standard deviation or variance.

While the movement in ranking by the gas distribution industry during the two time periods was substantial, equally as important was how the distribution industry fared in comparison with other industries. By comparing Tables 4 and 5, it can be seen that 28 industries became relatively riskier during the most recent period. However, of the 28, only two industries -- railroad equipment and original equipment auto parts -- moved more slots in the risk rankings than the gas distribution industry did.

On an absolute basis, only 16 of the 52 industries registered increased variability of earnings between the two periods. As Tables 4 and 5 reflect, two of the 16 industries suffering increased variability -- and, consequently, increased risk -- were natural gas distributors and pipelines.

For natural gas pipelines, the relative change in variability was not as dramatic as it was for distributors; however, there was a noticeable change in the pipelines' risk. From the 1972-1976 period to the 1977-1981 period, the pipelines' coefficient of variation rose from .0578 to .0728. During the 1972-1976 period, pipelines ranked 45th out of 52 industries in terms of variability of earnings, i.e., only 13.5 percent of industries surveyed were less risky. This again lends credence to the argument that pipelines were among the least risky of industries. As Table 5 indicates, during the 1977-1981 period pipelines became the 35th most risky industry -- almost 33 percent of industries were less risky than pipelines during the period. Thus, for the pipelines, as well as the distributors, the nature of risk changed sharply from the first period to the later period.

In terms of financial risk, Tables 6 and 7 present data on the relative degree of leverage for 48 industries. As the tables indicate, for both periods, 1974 and 1982, gas distributors and pipelines have historically exhibited a relatively higher degree of leverage than other industries. There are a number of reasons for this; namely, the historically lower business risk as reflected in stable earnings patterns and the capital intensity of the industries.

As Table 6 indicates, in 1974 about 90 percent of all industries exhibited a lower degree of financial risk than the gas distribution industry Over 83 percent of industries had a lower degree of financial risk than the gas pipeline industry. The only industries exhibiting greater leverage than the regulated gas industries in 1974 were airlines, telecommunication, electric utilities, and financial services. By 1982, however, while the absolute level of fiancial risk declined for both the distribution and pipeline industries (Table 7), the relative degree of risk did not change substantially. Over 81 percent of industries exhibited a lower degree of financial risk than the distribution industry, while close to 70 percent of industries exhibited less financial risk than the pipelines.

As the attached tables indicate, the level of risk for the regulated gas industries has increased from the 1972-1976 period to the 1977-1981 period. The increased risk measured primarily in terms of variability of earnings has resulted from a number of factors. Conditions generally considered to be responsible for the increased risk include the rising cost of gas[4] which reduces the ability of the regulated gas industries to adapt to changing competitive conditions (conditions which have been changing dramtically), inflation, fluctuating interest rates and changing regulatory conditions. To the extent that these factors will continue in the future, the industries' level of risk can be expected to increase further.

F. Conclusions

Regulated industries must compete with all industries, both regulated and nonregulated, in the capital markets. In order to attract capital to maintain their financial health, the natural gas distribution and transmission companies must be able to offer a return to investors commensurate with the relative risk of their investment. Historically, in comparison with nonregulated industries, the regulated natural gas companies have been assumed to be of relatively low risk because of their stable earnings patterns. This analysis has shown that these companies did in fact have relatively stable earnings patterns during the 1972-1976 period (although the companies faced risks of a different nature -- in terms of supply shortages, high degrees of leverage, etc.) However, this analysis finds that the nature of risk for the regulated gas industries has changed. Table 1 reflects the extent to which many other industries are less risky than the gas distribution and transmission industries. As the table shows, the relative business risk of the regulated gas industries increased sharply from the 1972-1976 period to the 1977-1981 periods. In comparison with the regulated gas industries, many more industries exhibited less variability in earnings (business risk) in the latter period. In terms of degree of leverage (financial risk) during the 1974-1982 period the regulated gas industries continued to exhibit greater financial risk than many industries. Thus, the gas distribution and transmission industries today exhibit relatively greater overall investment risk than in previous periods, necessitating cost of capital adjustments that reflect these changed conditions.

Failure of those maintaining oversight of the earnings of the regulated gas industries to acknowledge the increased risk will result in greater difficulty in attracting capital at a competitive and reasonable cost. Inability to attract capital on comparable terms with other industries competing in the capital markets will result, in the long run, in higher rates to the consumer.

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[4] A recent A.G.A. study found that costs under the control of the regulated gas industry declined as a percentage of the average retail gas price from 49 percent in 1971 to only 28 percent in 1981. See "Cost Components of the Average Gas Price," American Gas Association, (March 4, 1983), p. 1.

TABLE 1

SUMMARY TABLE

CHANGES IN RELATIVE INVESTMENT RISK FOR GAS DISTRIBUTION AND PIPELINE INDUSTRIES

Risk Measure	Distribution Industry	Pipeline Industry
	% of Industries Exhibiting Less Risk	
Variability of Return on Total Capital		
1972 - 1976	3.8	30.2
1977 - 1981	28.3	47.2
Variability of Return on Net Worth		
1972 - 1976	9.6	13.5
1977 - 1981	51.9	32.7
Debt/Equity Ratio		
1974	89.6	81.3
1982	81.3	68.8

Sources: Value Line Investment Survey and A.G.A. Gas Facts

TABLE 2

VARIABILITY IN RETURN ON TOTAL CAPITAL[1]
1972 - 1976

(Ranked by Coefficient of Variation)

Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
1. Real Estate	.5468	2.7447	7.5330	5.02
2. Toys & School Supplies	.4503	3.7733	14.2376	8.38
3. Coal/Uranium/Geothermal	.4793	6.4896	42.1144	13.54
4. Sugar	.4435	4.5504	20.7064	10.26
5. Maritime	.4028	2.4653	6.0776	6.12
6. Steel (General)	.3220	3.1492	9.9176	9.78
7. Steel (Integrated)	.3207	2.4441	5.9736	7.62
8. Oilfield Services/Equipment	.2267	2.7614	7.6256	12.18
9. Home Appliances	.2107	2.2042	4.8584	10.46
10. Textiles	.2081	1.2280	1.5080	5.90
11. Metal Fabricating	.2078	1.7165	2.9464	8.26
12. Grocery Store	.2055	1.4959	2.2376	7.28
13. Electrical Equipment	.2025	2.0455	4.1840	10.10
14. Retail (Special Lines)	.1868	2.1039	4.4264	11.26
15. Paper & Forest Products	.1834	1.8051	3.2584	9.84
16. Advertising	.1767	2.5483	6.4936	14.42
17. Broadcasting/Cable TV	.1688	2.0655	4.2664	12.24
18. Apparel	.1629	1.1792	1.3904	7.24
19. Machinery	.1601	1.7607	3.1000	11.00
20. Precision Instruments	.1585	1.7314	2.9976	10.92
21. Aerospace	.1497	1.2816	1.6424	8.56
22. Chemical (Specialty)	.1470	1.5025	2.2576	10.22
23. Trucking & Transport Leasing	.1436	1.8691	3.4936	13.02
24. Medical Services	.1423	.8424	.7096	5.92
25. Auto Parts (Replacement)	.1355	1.3764	1.8944	10.16
26. Tire & Rubber	.1326	.9550	.9120	7.20
27. Electronics	.1296	1.4051	1.9744	10.84
28. Auto Parts (Original Equipment)	.1263	1.3063	1.7064	10.34
29. Brewing	.1218	1.0911	1.1904	8.96
30. Chemical (Basic)	.1205	1.3185	1.7384	10.94
31. Retail Stores	.1190	1.1089	1.2296	9.32

Table 2 (Continued)
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Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
32. Building	.1160	.9887	.9776	8.52
33. Industrial Services	.1134	1.0365	1.0744	9.14
34. Shoe	.1098	1.2784	1.6344	11.64
35. Machine Tool	.1062	.8602	.7400	8.10
36. Packaging & Containers	.1016	.9432	.8896	9.28
37. NATURAL GAS PIPELINES[4]	.1005	.9038	.8169	8.99
38. Drugstore	.0910	1.0088	1.0176	11.08
39. Newspaper	.0893	1.1289	1.2744	12.64
40. Finance	.0766	.5913	.3496	7.72
41. Soft Drink	.0718	1.2066	1.4560	16.80
42. Food Processing	.0683	.7239	.5240	10.60
43. Publishing	.0676	.6356	.4040	9.40
44. Multiform	.0643	.4690	.2200	7.30
45. Railroad Equipment	.0607	.4858	.2360	8.00
46. Toiletries/Cosmetics	.0589	.9826	.9656	16.68
47. Fast Food	.0524	.6375	.4064	12.16
48. Drug (Ethical)	.0529	.8754	.7664	16.54
49. Telecommunications	.0458	.3007	.0904	6.56
50. Drug (Proprietary)	.0403	.6615	.4376	16.42
51. NATURAL GAS DISTRIBUTORS[4]	.0374	.2674	.0715	7.15
52. Household Products	.0283	.3763	.1416	13.32
53. Health Care/Hospital Supplies	.0134	.1625	.0264	12.16

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[1] Return on Total Capital is defined as:

$$\frac{\text{Net Income + (1- tax rate) Interest on Long-Term Debt}}{\text{Long-Term Debt + Net Worth (less deferred taxes)}}$$

[2] The coefficient of variation is a measure of relative variation of a series of data, i.e., a measure that expresses the size of the variation relative to the size of the quantity being measured. The coefficient expresses the degree of instability per percentage point of return.

[3] The standard deviation expresses variation in terms of the distances (deviations) by which the various numbers depart from the mean. The variance is calculated by squaring the deviations and then averaging their squares. The square root of the variance is the standard deviation. Neither the standard deviation nor the variance provides information as to *relative* variability.

[4] Gas industry data derived from A.G.A. *Gas Facts*, various issues.

Source: *Value Line Investment Survey*, various issues, except as noted.

TABLE 3

VARIABILITY IN RETURN ON TOTAL CAPITAL[1]
1977 - 1981

(Ranked by Coefficient of Variation)

Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
1. Sugar	.5331	4.5504	20.7064	8.12
2. Steel (Integrated)	.3962	2.4441	5.9736	5.70
3. Tire & Rubber	.2915	.9550	.9120	5.84
4. Steel (General)	.2759	3.1492	9.9176	11.60
5. Auto Parts (Original Equip.)	.2454	1.3063	1.7064	10.66
6. Textiles	.2365	1.2280	1.5080	6.56
7. Metal Fabricating	.1617	1.7165	2.9464	12.50
8. Real Estate	.1597	2.7447	7.5330	6.20
9. Finance	.1547	.5913	.3996	7.74
10. Broadcasting/Cable TV	.1538	2.0655	4.2664	12.82
11. Paper & Forest Products	.1536	1.8051	3.2584	10.48
12. Apparel	.1533	1.1792	1.3904	10.84
13. Oilfield Services/Equipment	.1513	2.7614	7.6256	15.20
14. Railroad Equipment	.1372	.4858	.2360	9.16
15. Multiform	.1352	.4690	.2200	9.22
16. Machine Tool	.1320	.8602	.7400	13.28
17. Building	.1306	.9887	1.5521	10.50
18. Coal/Uranium/Geothermal	.1239	6.4896	42.1144	9.28
19. Home Appliances	.1231	2.2042	4.8584	11.62
20. Advertising	.1151	2.5483	6.4936	18.76
21. Toys & School Supplies	.1141	3.7733	14.2376	12.72
22. Trucking & Transport Leasing	.1102	1.8691	3.4936	14.30
23. Electronics	.1102	1.4051	1.9744	12.24
24. Auto Parts (Replacement)	.1081	1.3764	1.8944	11.10
25. Industrial Services	.1046	1.0365	1.0744	12.34
26. Chemical (Specialty)	.0964	1.5025	2.2576	13.18
27. Retail Stores	.0958	1.1089	1.2296	9.48
28. NATURAL GAS PIPELINES[4]	.0934	1.1239	1.2631	12.03
29. Health Care/Hospital Supplies	.0925	.1625	.0264	13.56
30. Brewing	.0813	1.0911	1.1904	9.90
31. Precision Instruments	.0790	1.7314	2.9976	14.44

Table 3 (Continued)
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Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
32. Chemical (Basic)	.0786	1.3185	1.7384	10.26
33. Aerospace	.0785	1.2816	1.6424	13.44
34. Maritime	.0733	2.4653	6.0776	10.72
35. Retail (Special Lines)	.0651	2.1039	4.4264	13.58
36. Grocery Store	.0640	1.4959	2.2376	8.36
37. Medical Services	.0639	.8424	.7096	9.16
38. NATURAL GAS DISTRIBUTORS[4]	.0613	.5645	.3187	9.21
39. Newspaper	.0590	1.1289	1.2744	16.02
40. Toiletries/Cosmetics	.0490	.9826	.9656	16.66
41. Packaging & Containers	.0483	.9432	.8896	8.62
42. Electrical Equipment	.0461	2.0455	4.1840	15.10
43. Drug (Ethical)	.0440	.8754	.7664	16.40
44. Machinery	.0432	1.7607	3.1000	12.64
45. Telecommunications	.0424	.3007	.0904	7.90
46. Drug (Proprietary)	.0415	.6615	.4376	16.94
47. Publishing	.0377	.6356	.4040	13.58
48. Drugstore	.0326	1.0088	1.0176	13.60
49. Fast Food	.0285	.6375	.4064	12.42
50. Soft Drink	.0265	1.2066	1.4560	17.40
51. Household Products	.0204	.3763	.1416	14.06
52. Shoe	.0159	1.2784	1.6344	13.80
53. Food Processing	.0149	.7239	.5240	11.74

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[1] Return on Total Capital is defined as:

$$\frac{\text{Net Income} + (1-\text{ tax rate})\text{ Interest on Long-Term Debt}}{\text{Long-Term Debt} + \text{Net Worth (less deferred taxes)}}$$

[2] The coefficient of variation is a measure of relative variation of a series of data, i.e., a measure that expresses the size of the variation relative to the size of the quantity being measured. The coefficient of variation expresses the degree of instability per percentage point of return.

[3] The standard deviation expresses variation in terms of the distances (deviations) by which the various numbers depart from the mean. The variance is calculated by squaring the deviations and then averaging their squares. The square root of the variance is the standard deviation. Neither the standard deviation nor the variance provides information as to *relative* variability.

[4] Gas industry data derived from A.G.A. *Gas Facts*, various issues.

Source: *Value Line Investment Survey*, various issues, except as noted.

TABLE 4
VARIABILITY IN RETURN ON NET WORTH[1]
1972 - 1976

(Ranked by Coefficient of Variation)

Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
1. Maritime	.5387	6.1089	37.3184	11.34
2. Toys & School Supplies	.5351	5.1694	26.7224	9.66
3. Coal/Uranium/Geothermal	.4708	9.0307	81.5536	19.18
4. Sugar	.4534	6.0487	36.5864	13.34
5. Steel (Integrated)	.3333	3.0997	9.6080	9.30
6. Steel (General)	.3307	3.9154	15.3304	11.84
7. Textiles	.2507	1.7600	3.0976	7.02
8. Grocery Store	.2374	2.0605	4.2436	8.68
9. Oilfield Services/Equipment	.2349	3.7860	14.3336	16.12
10. Metal Fabricating	.2307	2.4916	6.2080	10.80
11. Home Appliances	.2226	2.7781	7.7176	12.48
12. Electrical Equipment	.2091	2.6265	6.8984	12.56
13. Paper & Forest Products	.1954	2.6374	6.9560	13.50
14. Apparel	.1778	1.5396	2.3704	8.66
15. Machinery	.1777	2.4919	6.2096	14.02
16. Medical Services	.1770	1.8478	3.4144	10.44
17. Advertising	.1726	2.6230	6.8800	15.20
18. Tire & Rubber	.1709	1.5753	2.4816	9.22
19. Retail (Special Lines)	.1611	2.0913	4.3736	12.98
20. Chemical (Specialty)	.1596	1.9561	3.8264	12.26
21. Broadcasting/Cable TV	.1581	2.5167	6.3336	15.92
22. Finance	.1579	1.5786	2.4920	10.00
23. Trucking & Transport Leasing	.1484	2.5227	6.3640	17.00
24. Aerospace	.1478	1.6080	2.5856	10.88
25. Building	.1416	1.4873	2.2120	10.50
26. Auto Parts (Replacement)	.1405	1.7286	2.9880	12.30
27. Electronics	.1402	1.7944	3.2200	12.80
28. Precision Instruments	.1396	1.6888	2.8520	12.10
29. Auto Parts (Original Equipment)	.1345	1.6407	2.6920	12.20
30. Chemical (Basic)	.1339	1.8693	3.4944	13.96
31. Brewing	.1304	1.4009	1.9624	10.74

Table 4 (Continued)
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Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
32. Industrial Services	.1265	1.4190	2.0136	11.22
33. Retail Stores	.1152	1.3106	1.7176	11.38
34. Machine Tool	.1146	1.0796	1.1656	9.42
35. Packaging & Containers	.1028	1.2290	1.5104	11.95
36. Shoe	.1014	1.3951	1.9464	13.76
37. Railroad Equipment	.0971	1.1689	1.3664	12.04
38. Multiform	.0853	.8823	.7784	10.34
39. Drugstore	.0835	1.0800	1.1664	12.94
40. Newspaper	.0831	1.1798	1.3920	14.20
41. Publishing	.0713	.7605	.5784	10.66
42. Toiletries/Cosmetics	.0674	1.3008	1.6920	19.30
43. Food Processing	.0661	.8570	.7344	12.96
44. Soft Drink	.0635	1.2066	1.4560	19.00
45. NATURAL GAS PIPELINES[4]	.0578	.7774	.6044	13.45
46. Fast Food	.0519	.9402	.8840	18.10
47. NATURAL GAS DISTRIBUTORS[4]	.0479	.5224	.2729	10.90
48. Telecommunications	.0438	.4317	.1864	9.86
49. Drug (Proprietary)	.0326	.5953	.3544	18.26
50. Drug (Ethical)	.0272	.5122	.2624	18.84
51. Household Products	.0230	.3555	.1264	15.46
52. Health Care/Hospital Supplies	.0220	.3187	.1016	14.48

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[1] Return on Net Worth is defined as: $\frac{\text{Net Income}}{\text{Common Equity and Preferred Stock}}$

[2] The coefficient of variation is a measure of relative variation of a series of data, i.e., a measure that expresses the size of the variation relative to the size of the quantity being measured. The coefficient expresses the degree of instability per percentage point of return.

[3] The standard deviation expresses variation in terms of the distances (deviations) by which the various numbers depart from the mean. The variance is calculated by squaring the deviations and then averaging their squares. The square root of the variance is the standard deviation. Neither the standard deviation nor the variance provides information as to relative variability.

[4] Gas industry data derived from A.G.A. Gas Facts, various issues.

Source: Value Line Investment Survey, various issues, except as noted.

TABLE 5

VARIABILITY IN RETURN ON NET WORTH[1]
1977 - 1981

(Ranked by Coefficient of Variation)

Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
1. Sugar	.5865	5.5018	30.2696	9.38
2. Steel (Integrated)	.4920	3.2672	10.6744	6.64
3. Finance	.4287	3.6351	13.2136	8.48
4. Tire & Rubber	.3766	2.5382	6.4424	6.74
5. Textiles	.2948	2.2405	5.0200	7.60
6. Auto Parts (Original Equipment)	.2641	3.2641	10.6544	12.36
7. Steel (General)	.2508	2.9446	8.6704	11.74
8. Railroad Equipment	.1793	2.4523	6.0136	13.68
9. Paper and Forest Products	.1707	2.3048	5.3120	13.50
10. Building	.1669	2.2258	4.9542	13.34
11. Apparel	.1589	2.0527	4.2136	12.92
12. Broadcasting/Cable TV	.1535	2.6225	6.8776	17.08
13. Coal/Uranium/Geothermal	.1521	1.9590	3.8376	12.88
14. Home Appliances	.1437	1.9744	3.8984	13.74
15. Toys & School Supplies	.1384	2.1257	4.5184	15.36
16. Electronics	.1372	1.9835	3.9344	14.46
17. Machine Tool	.1366	2.1563	4.6496	15.78
18. Oilfield Services/Equipment	.1357	2.5858	6.6864	19.06
19. Metal Fabricating	.1351	2.0380	4.1536	15.08
20. Auto Parts (Replacement)	.1322	1.7348	3.0096	13.12
21. Trucking & Transport Leasing	.1229	2.0568	4.2304	16.74
22. Industrial Services	.1190	1.8271	3.3384	15.36
23. Advertising	.1118	2.2402	5.0184	20.04
24. Retail Stores	.1092	1.2859	1.6536	11.78
25. NATURAL GAS DISTRIBUTORS[4]	.1000	1.2747	1.6248	12.75
26. Chemical (Specialty)	.0999	1.6020	2.5664	16.04
27. Multiform	.0979	1.2221	1.4936	12.48
28. Grocery Store	.0834	.9757	.9520	11.70
29. Brewing	.0813	.9541	.9104	11.74
30. Precision Instruments	.0810	1.2734	1.6216	15.72
31. Aerospace	.0775	1.2274	1.5064	15.84

Table 5 (Continued)
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Industry	Coefficient of Variation[2]	Standard Deviation[3]	Variance[3]	Average Rate of Return
32. Medical Services	.0758	1.2706	1.6144	16.76
33. Health Care/Hospital Supplies	.0752	1.1662	1.3600	15.50
34. Chemical (Basic)	.0737	.9786	.9576	13.28
35. NATURAL GAS PIPELINES[4]	.0728	1.1320	1.2814	15.55
36. Retail (Special Lines)	.0540	.9912	.9824	18.36
37. Fast Food	.0488	.9287	.8624	19.04
38. Machinery	.0453	.6969	.4856	15.38
39. Drug (Proprietary)	.0447	.8333	.6944	18.64
40. Telecommunications	.0447	.5192	.2696	11.62
41. Toiletries/Cosmetics	.0443	.8424	.7096	19.02
42. Newspaper	.0437	.8035	.6456	18.38
43. Drug (Ethical)	.0422	.7985	.6376	18.92
44. Drugstore	.0417	.6794	.4616	16.28
45. Maritime	.0375	.6888	.4744	18.36
46. Packaging & Containers	.0335	.3655	.1336	10.92
47. Publishing	.0325	.5122	.2624	15.76
48. Electrical Equipment	.0270	.4707	.2216	17.42
49. Soft Drink	.0260	.5314	.2824	20.46
50. Household Products	.0233	.3795	.1440	16.30
51. Shoe	.0189	.3162	.1000	16.70
52. Food Processing	.0135	.1939	.0376	14.32

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[1] Return on Net Worth is defined as: $\frac{\text{Net Income}}{\text{Common Equity and Preferred Stock}}$

[2] The coefficient of variation is a measure of relative variation of a series of data, i.e., a measure that expresses the size of the variation relative to the size of the quantity being measured. The coefficient of variation expresses the degree of instability per percentage point of return.

[3] The standard deviation expresses variation in terms of the distances (deviations) by which the various numbers depart from the mean. The variance is calculated by squaring the deviations and then averaging their squares. The square root of the variance is the standard deviation. Neither the standard deviation nor the variance provides information as to relative variability.

[4] Gas industry data derived from A.G.A. Gas Facts, various issues.

Source: Value Line Investment Survey, various issues, except as noted.

TABLE 6

DEBT/EQUITY RATIOS[1]
FOR
48 INDUSTRIES IN 1974[2]

1.	Airlines	1.7
2.	Telecommunications	1.1
3.	Electric Utilities	1.0
4.	Financial Services	1.0
5.	NATURAL GAS DISTRIBUTORS	1.0
6.	NATURAL GAS PIPELINES	0.9
7.	Contractors-Home Building	0.9
8.	Discount & Variety Stores	0.9
9.	Entertainment	0.8
10.	Lumber	0.8
11.	Forest Products	0.6
12.	Railroads	0.6
13.	Packaging	0.5
14.	Rail Equipment	0.5
15.	Tire & Rubber	0.5
16.	Housewares, Furnishings	0.5
17.	Supermarkets	0.5
18.	Department Stores	0.5
19.	Recreation	0.5
20.	Drug Chains	0.4
21.	Food Distributors	0.4
22.	Tobacco	0.4
23.	Shoes	0.4
24.	Textiles	0.4
25.	Agricultural Commodities	0.4
26.	Meatpackers	0.4
27.	Aerospace & Defense	0.4
28.	Vehicles (Autos & Trucks)	0.4
29.	Specialty Equipment	0.4
30.	Office Equipment Services	0.4
31.	Electronics	0.4
32.	Chemicals	0.4
33.	Nonferrous Metals	0.4
34.	Steel	0.4
35.	Energy	0.4
36.	Banks	0.4
37.	Computers	0.3
38.	Production Equipment	0.3
39.	Electrical Equipment	0.3
40.	Building Equipment	0.3
41.	Contractor-Heavy Construction	0.3
42.	Appliances	0.3
43.	Beverages	0.3
44.	Toiletries & Cosmetics	0.3
45.	Publishing	0.3
46.	Cement & Gypsum	0.2
47.	Drugs	0.1
48.	Insurance	0.0

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[1] Calculated by dividing long-term debt by the sum of stockholders' equity, minority stockholders' interest and accululated deferred taxes and investment tax credits.

[2] The data for 1974 are as published in the January 1, 1975 issue of Forbes, except for gas industry data which were developed from A.G.A. Gas Facts.

TABLE 7

DEBT/EQUITY RATIOS[1] FOR 48 INDUSTRIES IN 1982[2]

1.	Airlines	1.6	25.	Packaging	0.4
2.	Railroad Equipment	1.2	26.	Steel	0.4
3.	Financial Services	1.0	27.	Building Equipment	0.4
4.	Supermarkets	0.9	28.	Housewares, Furnishings	0.4
5.	Electric Utilities	0.9	29.	Banks	0.3
6.	Telecommunications	0.9	30.	Chemicals	0.3
7.	NATURAL GAS DISTRIBUTORS[3]	0.8	31.	Electronics	0.3
8.	Contractors-Home Building	0.8	32.	Computers	0.3
9.	Discount & Variety Stores	0.8	33.	Office Equipment/Services	0.3
10.	NATURAL GAS PIPELINES[3]	0.6	34.	Production Equipment	0.3
11.	Cement & Gypsum	0.6	35.	Specialty Equipment	0.3
12.	Meatpackers	0.6	36.	Contractors-Heavy Construction	0.3
13.	Food Distributors	0.6	37.	Vehicles (Autos & Trucks)	0.3
14.	Department Stores	0.6	38.	Aerospace & Defense	0.3
15.	Drug Chains	0.6	39.	Beverages	0.3
16.	Energy	0.5	40.	Tobacco	0.3
17.	Forest Products	0.5	41.	Recreation	0.3
18.	Nonferrous Metals	0.5	42.	Publishing	0.2
19.	Lumber	0.5	43.	Entertainment	0.2
20.	Tire & Rubber	0.5	44.	Toiletries & Cosmetics	0.2
21.	Railroads	0.5	45.	Shoes	0.2
22.	Appliances	0.5	46.	Drugs	0.2
23.	Agricultural Commodities	0.4	47.	Electrical Equipment	0.2
24.	Textiles	0.4	48.	Insurance	

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[1] Calculated by dividing long-term debt by the sum of stockholder's equity, minority stockholders' interest and accumulated deferred taxes and investment tax credits.

[2] The data for 1982 are as provided in the January 3, 1983 issue of Forbes.

[3] Gas industry data are for full year 1981, as provided in A.G.A. Gas Facts.

Source: Forbes, January 3, 1983, except as noted.

June 29, 1983

STATEMENT OF THE
AMERICAN IRON AND STEEL INSTITUTE (AISI)
TO THE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
REGARDING S.1174 TO AMEND THE
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The American Iron and Steel Institute (AISI) is pleased to submit the following statement of position regarding S.1174, the current proposal to amend the Public Utility Holding Company Act of 1935 (the Act). While S.1174 is a significant improvement over the proposals to repeal or amend the Act considered during 1982, AISI is unable to support it unless further modifications are made in the provisions regarding -

- exemptions from the Act, and related burden of proof issues;
- state regulatory agency access to holding company books and records;
- the Act's threshold requirement for application to holding company financing and diversification activities, and
- notice to PSC's with jurisdiction over a utility subsidiary of a holding company.

In this respect, AISI's position is similar to that of NARUC.

AISI is the principal trade association for the steel industry. Its 61 domestic member companies account for approximately 87% of the raw steel production capability in the United States. These AISI member companies use, in the manufacture of steel, about three percent of all the energy consumed in the United States. During 1982 - a devastating year for the steel industry of the United States - AISI member companies and other steel producers purchased 34.1 billion kilowatt hours of electricity. During 1981 - a more typical year - steel producers purchased 49.0 billion kilowatt hours of electricity. Moreover, the increased use of electric furnace steelmaking has increased the industry's relative consumption of purchased electricity. AISI thus has a significant interest in promoting the development and adoption of coordinated, rational and consistent Federal policies which will assure an adequate, reliable and efficient electricity supply for all users at prices based upon the costs incurred in serving those customers.

Electricity accounts for a significant portion of the cost of producing steel. A viable steel industry in the United States depends on the availability of electricity at reasonable prices; therefore AISI believes that Congress should consider the impact of any changes to the Act on electric utility ratepayers, and not just focus on the desires of those firms that advocate substantial modifications to the Act.

AISI is interested in both the continuation and the effective administration of the Act by the SEC. For nearly 50 years AISI members and other electric utility ratepayers and wholesale customers have enjoyed the protections afforded by the Act. Many of its major provisions remain relevant in today's economic and regulatory circumstances. While AISI supports modification of those portions of the Act that are duplicative of other federal or state statutes, or otherwise unnecessary, much of the Act continues to provide an important safety net for monopoly ratepayers. For example:

- The Act is regulatory in nature, and prohibits certain kinds of transactions and requires Commission approval of a variety of activities. The Commission is required to make financial and economic decisions.
- This is unlike the Securities Act of 1933 which relates solely to disclosure in the sale of securities to the public.
- This is also unlike the Securities and Exchange Act of 1934, which deals with reports required to be filed with the Commission, prohibits manipulation and fraud in the sale of securities, the full and fair presentation of financial statements by publicly-held companies, information required to be disclosed in take-over efforts, disclosure of facts in proxy statements, and oversight of the trading markets, clearing agencies and transfer agents.
- The SEC is not involved in the setting of rates under the Act. Retail rates are set by state public utility commissions; wholesale rates are set by the FERC.

- State PUC's usually have no jurisdiction over the activities of a holding company. This is particularly true where the holding company is incorporated in a state in which none of its subsidiary public utilities operates. In that instance, there is no way the PUC in the state in which the subsidiary utility does operate can obtain the books and records of the holding company.
- Similarly, if a service company is incorporated in a state in which none of the public utility companies operates, there is no way whereby those PUC's can examine the books and records of the service company. If the service company is organized by individuals - e.g., the president and other officers of the holding company - and makes no public offering of its securities, its financial statements would not have to be filed with the SEC under either the Securities Act or the Securities and Exchange Act.
- The Act also makes it difficult for any person to take over a registered or exempt holding company system. Before the take-over offer can be made, an application must first be filed with the SEC and its approval for the acquisition be obtained.

Thus the Act continues to provide important protections to consumers and ratepayers that are not duplicated by any other statutes, state or federal. Amendments to the Act, therefore, should be carefully analyzed to make sure that they do not eliminate or render inoperable these important consumer protections for monopoly ratepayers. As AISI noted in its statement submitted to this Subcommittee in June, 1982 opposing repeal of the Act, while the Act does require utilities subject to it to do significant planning, it has not prevented them from making acquisitions that are consistent with their purpose as utilities. The nine registered electric utility holding companies, as of December 31, 1982, had total assets in excess of $56 billion, with operating revenues of $21 billion. The registered companies have stated that compliance with the Act costs $500,000 or more per year.*/ Some - but not all claim - that compliance with the Act is excessively costly and burdensome. However, the registered holding companies are not small businesses. And, from the perspective of ratepayers, the cost of regulation under the Act does not seem out of proportion to the benefits granted by the monopoly franchise each utility enjoys. This is particularly true now that the financial condition of the electric utility industry has improved substantially since last year - improved much more so than that of the U.S. steel industry, for example, which suffered losses of over $2.8 billion in 1982.

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*/ As there are virtually no compliance burdens imposed on exempt holding companies, the "burden" argument is not made by them.

Exemptions from the Act

Section 4 of S.1174 would broaden the Act's exemption provision and narrow SEC authority to grant, deny, revoke or condition these exemptions. While AISI understands the desire of exempt companies to add "certainty" to the PUHCA §3 exemption process, requiring the SEC to grant unconditional exemptions - as S.1174 would do - eliminates all SEC administrative discretion in the exemption area, which seems to AISI to be both unwise and unnecessary. To date the SEC has not evidenced any intent to repeal exemptions, or even to scrutinize them closely. To the extent the "unless and except" clause operates as a disincentive to unrestrained diversification activities by electric utilities, it is justified, and in the public interest.

- AISI supports the NARUC suggestion that S.1174 be amended to include a provision which would expressly allow the SEC to make the granting of exemptions conditional upon terms determined by the SEC as necessary to protect the public interest.
- AISI also shares NARUC's view that the burden of proof should be on the party seeking exempt status, and that a lesser evidentiary standard - i.e.,

"a preponderance of the evidence" is a more appropriate standard than that proposed in S.1174. Accordingly, AISI supports the amendments to this effect proposed by NARUC in its June 14, 1983 testimony at p. 5, and the addition of a 90-day time limit on SEC final actions, as proposed at p. 6.

State Regulator Access to Books and Records

As AISI pointed out in its statement last year, state regulators must have effective access to a holding company's books and records. Different decisions by different states may have implications for the capital structure to be used for rate-setting purposes, and each PSC staff needs to be able to analyze the records of affiliates to insure that transactions between the utility and holding company affiliates do not harm ratepayers. Even those states that have affiliate transaction authority may have difficulty obtaining data from a holding company located outside the state. Thus it is basic that state PSC's have unimpeded access to all relevant information regarding the impact of holding companies upon utility subsidiaries within their jurisdictions.

Accordingly, the proposed new Section 3A in S.1194 that would give PSC's a new, federally enforceable right to obtain the books and records of any associate company within a registered or exempt holding company system is an important addition to the machinery of the Act, and should be enacted with the following amendments, so that it will be both effective and workable:

- there should be an affirmative books-and-records reporting requirement on all registered and exempt companies affected by the Act's provisions, particularly since S.1174 would both enlarge the number of holding companies and expand the specific company activities not otherwise subject to SEC regulation under the Act.
- After consultation with state PSC's, the SEC should be authorized to promulgate regulation mandating the periodic filing of information by holding companies regarding their non-utility business activities, their affiliate transactions, etc. The NARUC proposed amendment at p. 8 would accomplish this.

The S.1174 provisions, on the other hand, provide that state PSC's (1) identify documents sought in reasonable detail "before gaining access to them; (2) sustain a burden that the documents so identified are" necessary to the performance ... of functions imposed by law ...", and (3) file suit in federal district court to obtain requested data not supplied by the holding company or its affiliates. AISI does not consider the proposed machinery to be workable - particularly the federal judicial remedy - and there is no assurance that a state PSC would indeed obtain the data in a timely fashion.

The NARUC proposed amendment that the SEC craft appropriate regulations for data reporting makes for better regulatory and administrative sense, which is why AISI supports it.

Financing and Diversification Threshold

AISI agrees with the central thrust of S.1174, that SEC prior approval of each issue or non-utility investment is not necessary, in the public interest. The issue posed by the so-called threshold provisions of S.1174, however, is how many potentially significant holding company financing and diversification activities should be beyond SEC purview? Although the ten percent threshold standard appears to be a modest one, it is pegged to total capitalization (for securities issues) and total consolidated assets (for diversification), which for most registered holding companies today means freedom to invest up to $500 million in any nonutility business of its choice, with no regulatory scrutiny as to the potential impact of the investment on its electric utility subsidiaries in the several states in which they hold monopoly franchises. While AISI is committed to the goal of reducing unnecessary regulation, the S.1194 threshold is simply too high. AISI supports the NARUC proposed amendment that the threshold be set at five percent of the holding company's net investment in its utility subsidiary's rate base assets, as determined by the state PSC with jurisdiction over the affected utility, or alternatively, at ten percent of the value of the utility subsidiary's outstanding common stock.

AISI also supports the NARUC proposal that a cumulative ceiling on the total value of unregulated securities issues be established, beyond which the holding company would not be permitted to claim any of the securities review exemptions set out in the Act or available under SEC rules or orders. Otherwise, the various exemptions for securities issues not subject to SEC review could be aggregated to a very substantial level.

State PSC Participation in SEC Actions

So that the state PSCs may participate fully and effectively in any SEC proceedings or actions under the Act, it is essential that the appropriate PSCs receive contemporaneous notice when a holding company files a request for exemption, a declaration requesting approval of a general plan for securities issues, or applications for approval of a diversification plan or specific nonutility business acquisition. S.1174 provides for this in part, but should be amended to provide also for such notice as to registered holding company activities that fall below the threshold limit, and for declaration regarding securities issues under new Section 7(a) of the Act, as NARUC proposes.

Effective Date; Report to Congress

While many states are now considering additional legislative and regulatory measures to provide utility diversification oversight, sparked in part by the movement to modify or repeal the Act, they have not completed such action. So that the already complex federal-state matrix of regulatory responsibilities with respect to holding companies and exempt companies does not become even more complex, AISI again endorses the NARUC suggestion that there be a one-year delay in the effective date of any proposed changes to the Act. That will enable the states to enact laws in light of the changes in the Act.

Finally, the SEC should be directed to report periodically to Congress regarding the impact of any modifications to the Act, as NARUC proposes.

Conclusion

S.1174 represents a major step forward, to eliminate redundancies and streamline the Act for the 1980's and beyond. AISI has limited its focus to those areas of S.1174 that state regulators have identified as essential to amend so that the interests of monopoly ratepayers are protected.

AT&T

Lydell L. Christensen
Assistant Treasurer

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June 23, 1983

The Honorable Alfonse M. D'Amato
The United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

American Telephone and Telegraph Company and the Associated Bell System Companies (listed on Attachment A) make this response to address the comments of Dr. Richard E. Schuler, NYSPSC Commissioner on S. 1174, designed to reform the Public Utility Holding Company Act (PUHCA).

As currently written, the Securities and Exchange Commission ("SEC") is responsible for regulating electric and gas utility holding companies. Any subject holding company and any of its affiliates must gain prior SEC approval, on twenty days' notice, for sales of securities. In addition, among other things, the SEC is empowered to regulate: (1) holding companies' acquisitions of securities, utility assets and any other business interests; (2) borrowings by a holding company from a subsidiary; (3) holding company extensions of credit to subsidiaries; (4) dividends and debt retirements of holding companies and other affiliates; (5) sales of holding company subsidiaries' securities or utility assets; (6) holding company proxies; and (7) intra-system business transactions - including service and construction contracts for affiliates.

Generally, the bill, although it includes a new provision granting State Commissions a federally enforceable right to obtain the books and records of any member of a registered holding company system, aims to simplify SEC administration of the Act and to relax current restrictions on securities issuances and diversifications of regulated gas and electric utility holding companies. It would do this by: (1) broadening the SEC's power to exempt from PUHCA certain securities issuances where it finds such exemption to be consistent with the economic interests of investors and consumers; and (2) allowing the SEC to regulate non-exempt financings on the basis of pre-filed financing plans covering a two-year period instead of on a case-by-case basis. In addition, the bill would relax the law's restraints on diversification by creating an exemption threshold which would permit registered holding company systems to make non-utility investments without SEC approval of up to 10 per cent of consolidated assets. As to non-exempt diversification, the bill would require that acquisitions of non-utility business interests be specifically approved by the SEC or be consistent with a two-year diversification plan, approved by the SEC on sixty days' notice, with a right given to State Commissions to object.

As pointed out in the comments of John S. R. Shad, SEC Chairman, the PUHCA, as originally enacted, has accomplished its purpose and now applies to only twelve gas and electric holding companies to require prior SEC approval of their intra-system transactions, acquisitions and financings. Dr. Schuler, alluding to the momentous changes which have occurred and will occur in the telecommunications industry, suggests that the bill, which is in reality deregulatory in thrust, be amended to broaden the scope of the PUHCA to encompass the telecommunications industry. The telecommunications industry was rightfully excluded from the scope of the law in 1935 and the events of the intervening fifty years have done nothing but confirm the wisdom of that exclusion. Indeed, to the extent that the exclusion was based on the stability and financial integrity of the industry, as well as its vigorous regulation by state and federal authorities, the intervening decades' and particularly the recent years' events strengthen the case for exclusion; they certainly do not argue for adding layers of regulation.

Specifically, S. 1174 would continue in somewhat relaxed form the requirement that registered public utility holding companies gain prior SEC approval under PUHCA of covered financings and diversifications. As to securities financings, nothing useful would be gained by applying this layer of regulation to existing state and federal regulation of telephone industry public financings and capital structures. It is well known that such matters are fully and effectively regulated by the FCC, SEC and state authorities under the applicable provisions of the Federal Communications Act

("FCA"), the Securities Act of 1933 ("1933 Act"), the Securities Exchange Act of 1934, the Trust Indenture Act and various state blue sky and public service statutes. The whole thrust of modern securities regulation has been to achieve investor protection through an integrated and continuous disclosure system which has been coordinated with SEC procedures, such as 1933 Act Rule 415, which allows financing entities to make prompt and effective use of favorable market conditions. The telephone industry has raised billions of capital dollars operating within this federal and state regulatory framework and investors have been fully protected. It would be unwise to add PUHCA complications to this smooth and efficient process, because such complications, while not adding to investor protection, would hinder companies' access to capital markets.

The theme is the same regarding diversification - it is fully and effectively regulated by the FCA, state public service law and, as regards Bell System companies by the Consent Decree recently approved by Judge Greene in U.S. District Court for the District of Columbia. In addition to imposing rigorous accounting and separation controls, this system of regulation (which is under current and active FCC, State Commission and court oversight) requires specific regulatory or judicial approval (and, in some cases, fully separated subsidiary formats) for any subject company which seeks to enter non-tariffed businesses or non-natural-monopoly lines of services. Any attempt to add a layer of SEC review to this process would needlessly complicate and perhaps frustrate current regulation without adding anything to the process.

In short, it was wise to omit telecommunications holding companies from the reach of PUHCA to begin with and it is even wiser in relaxing PUHCA standards to leave that omission intact.

Very truly yours,

Lydell L. Christensen

ATTACHMENT A

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell, Incorporated
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
   and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

KM
F4I

Roger A. Young
President

Bay State Gas Company
120 Royall Street
Canton, Massachusetts 02021
(617) 828-8650

June 21, 1983

Honorable Alphonse M. D'Amato
520 Hart Building
2nd and C Streets, N.E.
Washington, DC 20510

Dear Senator:

We wish to register our support for S 1174. We understand hearings on the bill have concluded.

While the entire bill is reasonable, Section 4 of the bill, which adds a new sub-section 6 to Section 3(a) of the Public Utility Holding Company Act would be most beneficial to Bay State Gas Company. The passage of this section would enable us to diversify into energy-related businesses which, we feel, would benefit our customers and shareholders.

We respectfully request that this letter be made a part of the hearing record on this matter.

Very truly yours,

Roger A. Young

Roger A. Young
President

Statement of

John G. L. Cabot
Senior Vice President

Cabot Corporation

Mr. Chairman and Members of the Committee:

I am pleased to make this statement on behalf of Cabot Corporation in support of the Public Utility Holding Company Act of 1935. As Senior Vice President of Cabot Corporation, I am resonsible for the overall operation, profitability and return on investment of the company's Energy Group.

From the outset, let me say, Mr. Chairman, that Cabot Corporation is uniquely affected by the Public Utility Holding Company Act and we enthusiastically support S.1174. We see the bill as a major step forward in allowing utilities and diversified corporations, like Cabot, to operate in the most efficient, effective manner possible. In doing so, the ultimate beneficiaries will be the stockholders, who will benefit from a greater return on equity, and the consumer, who should enjoy lower rates in the long run.

Cabot Corporation

Cabot Corporation ("Cabot") was founded a little over 100 years ago. It is a Boston-based manufacturer with annual sales of approximately $1.6 billion. Our businesses include energy, specialty metals and performance chemicals.

In the Energy Group, Cabot explores for and produces crude oil and natural gas, operates gas processing plants, natural gas pipelines and a distribution system, and imports and sells liquefied natural gas (LNG).

In the Engineered Products Group, we produce and sell specialty metals, alloys, compounds and materials for use in the aerospace, chemical processing, nuclear, paper, pollution control, alumnimum and electronics industries; energy absorbing resins and noise control products are also manufactured by this group.

In the Performance Chemicals Group, Cabot is the leading worldwide producer of carbon black, a chemical used primarily as a reinforcing agent in rubber tires, and is the largest domestic producer of fumed silica, used principally as a reinforcing agent in silicone rubber and as a thickening agent in liquids.

Cabot Natural Gas Utility in West Virginia

A small part of Cabot's business is a state-regulated natural gas utility which operates in West Virginia as a division of Cabot. In calendar year 1982, Cabot utility revenues of $16 million represented about one percent of Cabot's consolidated worldwide sales. Being approximately 99 percent diversified puts us at the extreme end of the range of companies that have both utility and non-utility interests.

Cabot entered the utility business quite by accident. In the late 1800s and early 1900s, the company explored for and produced natural gas in West Virginia and Pennsylvania to supply its carbon black manufacturing operations. The company permitted rural West Virginians to purchase excess gas supplies from Cabot's pipelines. These sales became regulated as state and federal utility regulation evolved.

The Cabot utility is currently regulated by the West Virginia Public Service Commission.

A Public Utility within a Diversified Corporation

At the Subcommittee's 1982 hearings on the 35 Act, questions were raised about prudent diversification and associated risks. As a diversified concern with over $1.6 billion in sales, we believe we can address those concerns. As we told this subcommittee last year, the Cabot record confronts directly the implicit assumption in the 35 Act -- that mixing utility businesses with non-utility businesses is somehow bad.

Cabot has experienced outstanding growth in recent years. Our return on equity has averaged almost 21 percent over the last five years. We are a world leader in the carbon black and specialty metals markets. In short, we have not only successfully managed a utility business, we have also been successful at managing a diversified business. In fact, over the last decade we have had both the lowest retail gas rates of any major West Virginia utility and generally, a better record of gas availability during that same period.

The 35 Act's "Catch-22" Burdens on Cabot

Even though we have been a success in both utility and non-utility businesses, the 35 Act places a severe burden on our organization. While the utilities which would like to start diversifying have advised you of the problems caused for them by the 35 Act, Cabot is at the other end of the spectrum. The 35 Act forces us to organize our business in an awkward way and makes it very complicated for us to expand utility operations -- for example, to another state -- should we wish to do so.

Let me be more specific.

A utility has special regulatory requirements which argue for separating utility operations from other businesses within the overall corporate structure. The logical way for Cabot to do this would be to operate its West Virginia utility as a subsidiary. But, despite approaches to the Securities and Exchange Commission in 1968 and again in 1980, we have been unable to obtain an exemption from the 35 Act, and we have been forced to operate our utility in the parent company.

If we were to place our utility business in a subsidiary under the present law, the parent company would become a holding company. As such, we would have to divest all businesses not "reasonably incidental" to our utility business. This means we would have to divest ourselves of our 99 percent on non-utility businesses in order to keep the one percent utility business.

As a result, Cabot has been forced to operate its utility as a division, rather than as a wholly-owned subsidiary, with the entire parent company as the utility of record in West Virginia. This means, from a practical standpoint, economic inefficiencies are created that burden the corporation, its utility and its customers. For example, the reporting burden on the parent corporation is great. We believe that no counsel of any other major corporation would recommend it enter the utility business today unless the utility could operate as a subsidiary. In addition, in past proceedings before the state regulatory commission, neither the commission nor Cabot has been able to satisfactorily define what the utility is in terms of assets, debt and equity and liability for taxes. This has made ratemaking an uncertain procedure at best.

If the 35 Act were amended in the manner proposed by S. 1174, Cabot could operate the utility as a subsidiary. The utility would be a well-defined separate corporate entity with known assets, debt and equity and taxes, with the flexibility to assume a typical utility industry debt structure. Generally, utility industries are characterized by more favorable debt to equity ratios, which have historically reduced the cost of capital to utilities. We do not understand why Cabot or any other company should be prevented from organizing its businesses in such a straightforward, logical manner.

Clearly, the most important contribution we can make this year, as we did last year, is to reassure this subcommittee that reform of the Act is in the best interests of the consumer and the stockholder. A diversified company can be just as committed to its utility customers as a non-diversified enterprise. The ratepayers and stockholders can benefit from the relationship. There is no reason to continue to isolate utilities from other enterprises. They can be managed together, efficiently and profitably.

Again, let me be specific by demonstrating this point.

Cabot can sell gas more cheaply than others can because our West Virginia operations are a compact, efficient blend between the residential and industrial user, and the system is properly incorporated into the Cabot Energy Group. We are a large driller in West Virginia and have been in the business since the late 1800's. We began an aggressive gas development program in 1970. Our program was a success and, as it turns out, invaluable to the utility because enough new production was generated to more than cover our utility's needs. Each business -- production and distribution -- was run independently, run at its own pace and not as the handmaiden to the other. Thus, our natural gas production was expanded as fast as opportunity would allow, not just to supply our utility. The utility ultimately benefitted because we were never short of gas. In fact, we are unusal in the state because we have had no sales restrictions in the last decade. In short, we run our utility like a business, where we look for opportunities to blend the utility needs into our other businesses, not vice versa.

Protection of Public Interest Would Not Be Relaxed

An important public policy issue before the Congress is whether it is in the public interest to maintain the wall erected by the Act between public utilities and other businesses. We believe that this wall has created artificial economic distortions and that its removal would permit some benefits to accrue to utility customers. Again, there is no reason to believe that a utility cannot benefit from its association with a generally non-utility oriented business. The real question is not whether diversification is a good idea, because in some cases it is not, but whether it should be prohibited by statute in all cases and without recourse, even when it is a positive step. There are numerous checks, such as state regulatory authorities, to prevent poorly thought out diversification plans. But, there is no reason to penalize everyone, through a wide-ranging federal statute like the 35 Act, from pursuing prudent diversification practices.

In our experience, the general requirements for utility and non-utility management are similar; both need to maintain a desirable return on stockholders' equity and to set operating and financial objectives. Although techniques and technology used in operations may differ, the standards of efficiency, quality and properly adapting to new conditions and opportunities are equally important to both businesses. The question before this subcommittee is whether the 35 Act should continue to isolate utilities from the experience of market enterprises and vice versa.

S. 1174 and Cabot Corporation

Section 4 of S. 1174 would amend Section 3 of the 35 Act. Of direct importance to Cabot Corporation and the public policy interests which would be served by such amendment, the legislation would create a very narrowly drawn exemption from almost all provisions of the 35 Act. If enacted, section 3(a)(6) of the amended Act would read in respect to this issue as follows:

> Sec. 3. (a) The Commision, by rules and regulations upon its own motion, or by order upon application, shall unconditionally exempt any holding company, and every subsidiary company thereof as such, from all provisions of this title except section 3A and paragraph (2) of subsection (a) of section 9, unless and except insofar as the Commission, acting on its own motion or upon the request of a State commission having jurisdiction to regulate a public-utility company in the

> holding-company system, shall by order determine, by specific factual findings made upon clear and convincing evidence, that the exemption materially adversely affects the public-utility business of such holding-company system, if
>
> * * * * *
>
> (6) such holding company has only one subsidiary company which is a public-utility company and the operations of such subsidiary company as such do not extend beyond the State in which it is organized and States contiguous thereto: Provided, however, That such public-utility company may be a holding company which qualifies for an exemption under paragraph (2).

It is clear to us from our discussions with our counsel in this matter and counsel for the Utility Group which drafted this provision as well as with other authorities on the 35 Act, that if Cabot Corporation reorganizes its West Virginia natural gas utility operations into a subsidiary organized in that state and does not conduct its operations beyond that State and States contiguous thereto, that the provisions of section 3(a) as amended shall govern, and that the Securities and Exchange Commission, by rules and regulations upon its own motion or by order upon application, shall unconditionally exempt Cabot Corporation from the Act. Although we would prefer not to reincorporate our gas utility operations in the State of West Virginia for cost considerations, we would do so if the Congress passed S.1174 as currently drafted.

We have depicted what we know to be an unintentional ambiguity in the text of proposed section 3(a)(6) at paragraph

(6). The pronoun "it" appears in that text on page 5 at line 12 of the bill, and it refers to a subsidiary company, not a holding company, but inasmuch as both the phrase "subsidiary company" and the phrase "holding company" appear in that paragraph, we believe it should be clarified by technical amendment at the time of this Subcommittee's markup. We propose, therefore, that the word "it" be struck and the words "that subsidiary company" be inserted in lieu thereof. We understand that there is no objection to this amendment from within the industries.

We believe, further, that "unconditionally" refers, first, to the Commission following the mandate of Congress in enacting the additional exemption, i.e., it will not exercise some authority to preclude the exemption, and, second, to the Commission not attaching conditions to the exemption.

We hope that the Senate will reform the 35 Act this year so that Cabot can organize our utility as a subsidiary and other, even more restricted companies may begin to enjoy the flexibility and rewards of the marketplace.

STATEMENT OF THE
ELECTRICITY CONSUMERS RESOURCE COUNCIL
TO THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES
ON
S. 1174, THE PUBLIC UTILITY HOLDING COMPANY ACT AMENDMENTS OF 1983

The Electricity Consumers Resource Council (ELCON) is pleased to submit the following statement to the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs. The purpose of this statement is to present ELCON's views on Senate Bill 1174, entitled The Public Utility Holding Company Act Amendments of 1983. This bill is intended to modify certain provisions of The Public Utility Holding Company Act of 1935 (PUHCA or Act) to allow electric and gas utilities subject to the Act greater flexibility in issuing financial securities and in pursuing diversification activities.*/ If enacted into law, this bill (S. 1174) would have an important and substantial impact on utilities and their consumers.

ELCON is a group of sixteen large industrial consumers of electricity with facilities in most of the fifty states.**/ ELCON and its members advocate and promote the development and adoption of coordinated, rational and consistent federal, state and local policies which will assure an adequate, reliable and efficient electricity supply for all users at prices based on the costs incurred in serving customers.

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*/ ELCON recognizes that the provisions of the PUHCA and S. 1174 apply to both gas and electric utilities. However, our interest in the current proceeding applies only to the electric utility industry. Therefore, our comments on the proposed legislation are limited in applicability to the electric utility industry.

**/ Elcon member companies are: Air Products and Chemicals, Inc.; Airco, Inc.; Anheuser-Busch Companies, Inc.; Armco; Bethlehem Steel Corporation; Diamond Shamrock Corporation; E.I. du Pont de Nemours & Co.; FMC Corporation; General Motors Corporation; Kaiser Aluminum & Chemical Corporation; LCP Chemicals & Plastics, Inc.; Olin Corporation; PPG Industries, Inc.; Stauffer Chemical Co.; Union Carbide Corporation; United States Steel Corporation.

ELCON's members consume approximately ten percent of all electricity sold to industrial customers and nearly five percent of all electricity sold in the United States. Because of our members' use of electricity, ELCON has a significant, continuing interest in the electric utility industry and its regulation. We appreciate this opportunity to comment on the proposed legislation.

ELCON and its members support the efforts of the Reagan Administration and the Congress in identifying federal laws and regulations that impose excessive burdens on business, individuals and state and local governments and developing ways to alleviate those burdens. In appropriate cases, ELCON has supported the repeal or modification of federal laws and regulatory programs affecting the electric utility industry.

Summary:

ELCON supports those provisions of S. 1174 that enable all electric utilities to compete for financial capital on more equal terms. Those provisions of the bill would allow registered holding company systems greater flexibility in issuing securities and reduce Security and Exchange Commission (SEC) oversight of these utility activities. However, ELCON stands opposed to S. 1174 unless and until it is amended to meet the concerns of the National Association of Regulatory Utility Commissioners (NARUC) to assure that state regulators will be able to effectively monitor utility financial and diversification activities in order to adequately protect ratepayer interests.

Discussion:

Several proposals to repeal or substantially modify the PUHCA were introduced in the 97th Congress. At that time, ELCON performed an extensive analysis of the Act, the reasons for its enactment and the usefulness of its continued enforcement. ELCON filed comments with this Subcommittee and with the Subcommittee on Energy, Conservation and Power of the House Committee on Energy and Commerce opposing repeal of the Act but supporting modification of those portions of the Act that could be shown to be duplicative of other federal or state statutes or otherwise unnecessary.*/ Our analysis of the Act indicated that many of its major provisions remain relevant to today's economic circumstances, and that regulatory authorities, other than the SEC, simply do not have the necessary authority and/or expertise to effectively regulate the financial aspects and diversification activities of interstate public utility holding company operations. We submit that those findings remain just as true today.

ELCON believes that those who support modification of the PUHCA should consider the likely effect such action would have on the nation's electric utility customers. We would much prefer a streamlined federal statute stripped of regulatory redundancies that retains adequate oversight of the industry's structure. However absent PUHCA's authority, responsibility for overseeing development of the industry's structure falls largely upon state bodies. There is little consistency among state regulatory agencies and they lack jurisdiction over interstate matters.

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*/ Statement of the Electricity Consumers Resource Council to the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate, Regarding Proposals to Modify or Repeal the Public Utility Holding Company Act of 1935, June 23, 1982.

It does seem clear that registered holding company systems are subject to regulation of their securities issues to an extent that impairs their ability to provide the lowest cost service to their customers. Other, exempt holding company systems are not subject to the same stringent regulation. We see no reason for the additional restrictions on registered company financing operations and support those provisions of S. 1174 that reduce SEC oversight in this area, subject to the qualifications offered by the NARUC.

ELCON's Position:

The NARUC provided testimony on S. 1174 before this Subcommittee on June 14, 1983.*/ Within that testimony, the NARUC presented its position on the current legislation concluding that:

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*/ Statement of the National Association of Regulatory Utility Commissioners on S. 1174, A Bill Proposing the Public Utility Holding Company Act Amendments of 1983, June 14, 1983.

> . . . (W)ithout some degree of federal regulation, diversified interstate holding companies could in many instances preclude effective State utility regulation . . . The NARUC could support amendments to the Act) . . . only to the extent that they maintain a "core" of Federal oversight responsibilities with respect to holding companies currently affected by the PUHCA.

The NARUC then went on to outline, section by section, its views on the proposed legislation and its own proposed amendments to S. 1174 which are intended to assure effective state regulation of holding company activities.

Without repeating the testimony already offered, ELCON supports the position of the NARUC and recommends that S. 1174 be amended as proposed in the NARUC's testimony. If S. 1174 is amended to satisfy the concerns and requirements of the NARUC, then ELCON stands ready to support the resultant legislation.

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STATEMENT OF SCOTT RIDLEY

Regarding The

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

On Behalf Of

Consumer Energy Council of America

Consumer Federation of America

Environmental Action Foundation

Environmental Action, Inc.

Environmental Policy Center

Friends of the Earth

Natural Resources Defense Council

Nuclear Information and Resource Service

Public Citizen's Critical Mass Energy Project

Solar Lobby

Union of Concerned Scientists

June 30, 1983

Mr. Chairman and members of the Subcommittee, the above organizations wish to exprss their views on the subject of the proposed changes in the Public Utility Holding Company Act of 1935. We are eleven separate national environmental and consumer organizations, representing diverse labor and citizen groups.

We have joined together to prepare this statement because we are vitally concerned about preserving the Public Utility Holding Company Act of 1935. We are strongly opposed to amendments to the Act, which we believe would enable utility holding companies to use their peculiar corporate structures to overcharge consumers and deceive investors.

As you are well aware, consumers are already reeling under high utility bills. At a time when the electric industry faces decreasing demand and a peak reserve of 40 percent, and at a time when the gas industry faces massive uncertainty over the future of its regulation, we believe that altering federal oversight of holding companies could have a dire impact for both consumers and investors. It must also be noted that the Department of Energy has just issued a report pointing to the need for the utility industry to invest $700 billion in new plant construction. In that light, diversification and capital needs of subsidiary business become highly questionable. If amendments were to be considered, it is clear that now is not the time.

We believe the Holding Company Act to be a well conceived piece of legislation which is as important today as it was 48 years ago. The protection offered by the act addresses existing problems and not outdated concerns. All of the evidence thus far shows that utilities have enjoyed opportunities to diversify. They have not proven the difficulties on which they speculate. The current amendments proposed in the Senate and House, we believe, would create giant loopholes for holding companies. Under market pressures, the holding companies could be forced to take advantage of consumers and investors.

The Holding Company Act currently provides crucial protection to the general public. It prevents utility holding companies from abusing their monopoly privileges. And it keeps them from amassing the tremendous economic and political power which they wielded in the 1920s.

The paper empires, rampant stock swindles, and sweetheart deals which characterized the utilities of the 1920s are largely a thing of the past thanks to the Holding Company Act. Amendment of the law during turbulent economic times would be inviting utilities to abuse their investors and consumers once again.

As you are aware, the utility business in the United States is not a free enterprise; it is a monopoly. In exchange for the privilege of monopoly status, utilities must consent to regulation of their prices and business practices. The primary function of utility regulators is to prevent utilities from taking unfair advantage of their monopoly status by overcharging and otherwise abusing their customers.

A holding company is much more than a utility. Besides owning several separate utility companies in different states, a holding company might own a few coal mines, a railroad, and a "service company" which provides planning and engineering services to the other subsidiaries.

Regulation of holding companies poses some thorny questions for state utility commissions. Is a subsidiary utility paying a fair price for coal from a "captive" mine? Are the fees it pays to its service company for engineering services appropriate and necessary? Is the regulated portion of the holding company's business subsidizing other enterprises which must compete in free markets?

The potentials for conflicts of interest in a holding company structure are unending. When a holding company's utility service territories cross state lines, it is virtually impossible to regulate effectively at the state level. Since state regulators do not have access to all of the corporate records of a holding company's non-utility functions, they cannot be expected to protect from possible unfair business practices. Here, the Holding Company Act provides crucial protection by regulating transactions between affiliated companies under one holding company roof.

The possibility of such abuse is not just theoretical. Three major holding companies, American Electric Power, Middle South Utilities, and the Southern Company, each own fuel supply subsidiaries. In 1978, the captive coal subsidiaries were charging inflated coal prices to their utility operations resulting in overcharges to consumers. Captive coal abuses are a serious problem according to the FERC, which concluded in a February 1982 study that:

> "(1) Captive coal prices are on the average significantly higher than non-captive coal prices; (2) captive coal mines appear to be operating less efficiently than comparable non-captive coal mines; and (3) regulation of electric utility affiliated coal operations may be inadequate to assure the efficient management of captive mines and the reasonableness of captive coal prices."

In another example, last year the State of Illinois sued People's Energy Corp., a diversified natural gas holding company, for conspiring to "drain" its utility subsidiaries to finance its profitable non-utility operations. Examples like these suggest that there is plenty of work for the staff at the Securities and Exchange Commission to do in enforcing the Holding Company Act.

State Utility commissions are quite candid about their inability to properly regulate giant interstate holding companies. A recent resolution on the Holding Company Act adopted by the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC) states that "many state public utility regulatory commissions rely on provisions of the Act to assist in the effective regulation of electric and gas utilities within their jurisdiction." Under the Holding Company Act, for instance, the Securities and Exchange Commission regulates transactions between subsidiaries of registered holding companies, a power which state regulators lack.

Proponents of changes in the Holding Company Act maintain that the law stands in the way of utility efforts to diversify into non-utility businesses. Such diversification, they argue, can help to ease the financial difficulties experienced by utilities in recent years. The current law, however, does not prohibit all diversification into non-utility endeavors by holding companies. It simply protects investors and consumers from the risks of shaky and inappropriate investments by these utilities.

In addition to regulating diversification by the 12 registered holding companies, the SEC may also look at diversification plans of any of the approximately 80 utilities which have previously been granted exemptions from registering under the Act. These utilities are seeking to amend the law to eliminate any possible federal intervention in their diversification schemes.

We wonder why such an amendment might be necessary. The current provisions give the SEC the right to investigate questionable diversification efforts by exempt holding companies. A company with a solid diversification plan should have nothing to worry about. Perhaps these utilities want to avoid federal intervention if they become overextended in diversified investments.

The potental risks of diversification demand careful oversight by regulators. Speaking on diversification, Don C. Frisbee, Chairman of Pacific Power & Light Co., a heavily diversified utility, has stated:

> "You can make more mistakes in new business...(I)t is a path that has more dangers than opportunities because of the difficulties of trying to mix a typical management approach to the highly regulated utility business with the entrepreneurial approach needed in unregulated arenas."

Moreover, as NARUC explains,

> "The stockholders of a utility may win or lose as a result to diversification but the consumer bears the risk of failure without any commensurate participation in the benefits of success."

Advocates of changes in the Holding Company Act argue that diversification may be a partial solution to the electric utilities' recent financial difficulties. But new figures from the industry and Wall Street indicate that this financial crisis is all but over. A survey by Ebasco Services indicates that the power companies received $7.6 billion in rate increases last year. Figures from Wall Street also indicate that the electric utility industry was number three in industrial profit growth in 1982, an enviable position for an industry which claims to be in need of a loosening of federal regulation.

Under the Holding Company Act, registered holding companies must comply with strict rules when issuing new securities, and the SEC may block questionalbe financing schemes. Some utilities argue that the law inhibits creative financing methods needed to raise capital in today's rapidly changing markets. However, through current allowance of "shelf registration," a holding company system may gain SEC approval for a wide range of optional financing plans--well in advance of the need for capital.

The lack of regulatory oversight of "creative financing" was a key factor which caused Samuel Insull's holding company empire to collapse in the 1930s. At that time, fifty years ago, millions of investors and consumers suffered when the questionablo financial dealings of the holding companies were exposed; a situation which led to the passage of the Public Utility Holding Company Act.

Amendment of the Holding Company Act would allow companies to venture into creative proposals to raise capital which could prove detrimental to investors and ultimately to consumers. It would also allow holding companies to pursue non-utility investments. And further, other industrial holding companies such as banks, and oil companies could go freely into the utility business, building powerplants and other utility facilities. While this may initially appear to provide a healthy dose of competition, that competition is unlikely to develop since each utility needs a monopoly market to sell its power.

More likely, non-utilities would participate with utilities in joint construction projects. Non-utilities might simply buy out some existing utilities, without the risk of being regulated as holding companies.

Just imagine utilities in your state being owned by Exxon or Mobil. Where would they buy their fuel? And how much would they pay for it?

The current law does not prevent non-utilities from becoming involved in the utility business. But if they choose to make large utility investments, they must face the same type of regulation which Congress deemed necessary for any integrated utility holding company. Without these protections, we may see a recurrence of the far flung utility empires of the 1920s.

In conclusion, we believe that the Public Utility Holding Company Act is as important today as it was when it was written almost 50 years ago. This law protects consumers and investors, and it protects the utilities from themselves.

Even slight changes in the Act should not be taken lightly. Solomon Freedman, a 30-year veteran at the SEC, has observed that the Holding Company Act is an "integrated statute" and that altering any section could affect the authority of the entire law.

Citing their alleged financial crisis, gas and electric utilities say they must be freed from the restrictions of the Holding Company Act so they can pursue new business opportunities. The growing trend toward utility diversification, the current chaos in the gas industry, and the heavy reserves of the electric industry, soaring rates, and possible need for substantial capitilization within the industry, provide significant reasons not to amend the Act. On the contrary, these pressures within the utility industry require that efforts be made to maintain as much stability in federal policy as possible.

STATEMENT OF JAMES MCPHILLIPS
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
HONORABLE ALFONSE D'AMATO, CHAIRMAN

My name is James McPhillips. I am part owner and operator of McPhillips Plumbing & Heating located on Waterloo Road in Cleveland, Ohio. I have worked in the plumbing business in Cleveland for 45 years and our company was organized in 1907. We sell equipment and do residential, commercial and industrial plumbing and heating work in new and old buildings in the Cleveland area.

In addition to operating our own business, I am Vice President of the Heating and Cooling League in Cleveland. I taught at the school for master plumbers in Cuyahoga County. I am a state certified plumbing inspector and am the Energy Consultant for the Department of Housing Urban Development in Northeast Ohio. I am also past president of Cleveland Master Plumbers League.

Recently there has been a lot of national publicity about a few utilities that apparently have equipment merchandising programs that are unfair to local independent contractors. We think it would be unfair to our local gas company for your Committee to think East Ohio, which is part of the Consolidated Natural Gas Company, behaves like the examples that have been cited.

For all the years I have been in the plumbing business, the East Ohio Gas Company has been one of my most valuable trade allies. They have constantly come up with programs that help us sell our products and services to their customers. In no way do we consider the gas company to be competition. The only time they have actually sold appliances or equipment has been to help build a new market -- and they did this on gas conversion burners in the 1930s and 1940s -- gas lights and grills and gas air-conditioning in the 1950s and 1960s.

Once the market was proven, they got out of the business and turned it over to dealers. I know that the East Ohio Gas Company knows it is better off with us independent dealers selling and servicing appliances and equipment than it could possibly be if it had company stores.

The economy in Northeast Ohio is more like a depression than a recession; unemployment is still over 20% in some cities. Last year there was hardly any new construction in our area, so the gas company had a special program to build business for us in existing homes on their lines that had no gas service. The gas company offered a free water heater to each homeowner who would sign up for gas service. Plumbers got to install the gas service lines and houselines and we sold a lot of furnaces and boilers in those houses.

I know some plumbers complained about the free water heaters, but we think it is another good example of how the gas company helps us build business and, believe me, last year we really needed help. The plumbers in our area wish that program were still in effect this year.

In addition to these programs, the gas company's continued expansion of its lines into new areas has always meant more work for us plumbers and new business for all the construction trades in our area.

I know our gas company wants to get into the business of building and owning cogeneration plants. The big industrial plants in our area need anything that will help them be more competitive and I understand that these cogeneration plants help a lot in reducing energy costs. Well, the power companies, of course, are not interested in promoting these plants and Consolidated Natural Gas isn't allowed to because of the Public Utility Holding Company Act.

The plumbers in Northeast Ohio need the jobs that would be involved in building these plants and it is ridiculous for any plumbers association to argue against creating jobs for plumbers.

Thank you very much.

Mid-West Electric Consumers Association, Inc.

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Statement of Mid-West Electric Consumers Association In Opposition to Amendments to Public Utility Holding Company Act, S. 1174

Senate Committee on Banking, Housing and Urban Affairs

Mid-West Electric Consumers Association represents 3 million consumers in the states of Colorado, Iowa, Kansas, Minnesota, Montana, Nebraska, North Dakota, South Dakota, and Wyoming, who own and take electric service from 300 rural electric cooperatives and municipal electric utilities.

Mid-West expresses its strong opposition to S. 1174. This bill would emasculate the protections of the 1935 Public Utility Holding Company Act. The Act was passed by Congress to control rampaging private utilities whose activities were costing consumers and investors millions of dollars. The value of the Act has been proven. Those 1935 abuses have ended. It has been and will continue to be an effective consumer-protection statute by preventing abuses by private utility holding companies.

Congress made it clear in the Act what abuses were meant to be abolished. (15 U.S.C. 79a). A summary of these horrors provides the reason the Act should not be amended. Congress stated that "Public utility holding companies and their subsidiary companies are affected with a national interest," and said "... it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas may be adversely affected - when (1) investors cannot get information, (2) subsidiaries "are subjected to excessive charges," (3) control of subsidiaries affects rates, accounting practices and dividends, (4) growth of holding companies bears no relation to economy of management, and (5) lack of efficiency and adequacy of service, or public regulation. (15 U.S.C. 79b)

Mid-West represents consumers of electricity who own and operate their own electric systems. These consumers and consumers everywhere in the nation have been protected by the Holding Company Act throughout its existence. Arguments of private power companies that their financial positions require amendment of the Act are not persuasive. Nothing in the Act prevents them from financing needed facilities. Private companies are no diffferent than rural electric cooperatives or municipal electric utilities during times when interest rates are high and financing difficulties arise. Cooperatives, for example, finance many of their facilities in the same money market as private power companies. That financing in hard economic times may be difficult does not justify altering the Holding Company Act. Abuses spelled out by Congress in 1935 have not disappeared voluntarily. The Act made those abuses vanish. The electric utility industry is one of the few, if not the only, capital-intensive industries with active competition at both the wholesale and retail levels. The industry includes rural electric cooperatives, municipal electric utiltities, private power companies, and the federal government, which generates power for sale to consumer-owned utilities on a preferential basis. Over the decades there have been many Congressional benchmarks keeping competition alive for the benefit of the consumer. Some of these include the Federal Power Act, Part 1, enacted in 1920 to prevent private interests from controlling the nation's water resources in hydroelectric development; beginning in 1909, various federal acts authorizing building of federal dams and sales of power to consumer-owned electric utilities under the preference clause creating a "yardstick" of competition; creation of the Tennessee

Valley Authority in 1933, showing that a large federal utility could provide low cost power and other services; enactment of Part II of the Federal Power Act in 1935, insuring fair and reasonable wholesale rates; and the 1968 amendment to the Atomic Energy Act providing for prelicensing antitrust review.

Each one of the above Acts of Congress has reaffirmed the public's desire for stimulating and maintaining competition in the electric industry. The result is that every utility, particularly small consumer-owned utilities, cannot be excluded from vital transmission, generation, or power sales opportunities at the retail level. The consumer's choice is always alive under the present regulatory scheme. By a vote of the people utilities serving electric energy may be changed.

Undoing or changing the Holding Company Act presents a threat to competition in the electric industry. Instead of the careful restraints now in place as to forming subsidiaries of utility holding companies, the Act would be emasculated.

Instead of the "public interest" standard being applied by the Securities and Exchange Commission in passing on transactions by holding companies, S. 1174 substitutes the words "and unreasonable economic risk to investors or consumers." Such a change clearly shows that the heart of the Act is being removed. The public interest standard commands the Commission to act for consumers of energy. The new standard is plainly designed for investors. "Consumers" should not be asked to take "risks." They should be protected from monopoly pricing and assured a continous supply of reasonably-priced energy. The consumer of a private company does not share in its decision-making, as is the case with cooperative or municipal electric utilities. By being excluded, the results of any so-called "risk" is dumped on the consumer by private company management, not shared.

Allowing private companies to diversify into other business ventures almost assures the consumer of higher rates and poor service. The utility consumer must pay the price for failure in other business areas. Regulation at the least assures the consumer of reasonable rates. However, the issue here is also one of management. Profit-making entities by necessity will expend energy and money on the business giving the highest return. Under diversification, every incentive would be created to pay attention to non-utility ventures if they produced the greatest profit. Thus, the consumer, who has no voice when served by a private company, will pay for the inattention of management and failure to invest in needed utility facilities.

Diversification will also mean that other industries could be unfairly disrupted by the ability of large utilities to spend capital which otherwise would be used to serve energy consumers. One of the issues not answered by S. 1174 is just how funds collected from energy consumers can be used. If one dollar goes to other business ventures, that is too much. Energy consumers should be paying for energy, not financing other businesses. Why should existing non-utility businesses be faced with competition financed by large private power companies from their energy consumers?

Over the years the Public Utility Holding Company Act has been used by rural electric cooperatives and municipal electric utilities to secure fair competition for their consumer-owners. They have intervened to obtain access to transmission, wheeling services, and generation with success. Yet, S. 1174 defines "consumers" in such a way as to preclude consumer-owned utilities from seeking relief from anticompetitive practices by holding companies before the SEC. Under the proposal, if consumer-owned systems do not purchase from a subsidiary, they would not have standing as "consumers." Such a provision is clearly designed to exclude the effective intervention of consumer-owned utilities from challenging private company actions at the Commission.

The fact is that holding companies are now allowed under the Act to diversify into utility-related activities. However, such acquisitions are subject to the prior scrutiny of the Commission with opportunity for consumer-owned utilities and others to raise questions about such proposals. Considering the monopoly position that many large holding companies occupy, and their financial resources, the present system of prior approval must be retained. Under S. 1174, regulation is gutted in that the Commission may not act until after the harm to consumers or other utilities is done, and such action would take place under standards very favorable to the private utilities.

In this time of surplus power, private utilities should be concentrating their efforts on developing new markets for power. Improving regional and interregional transmission opportunities would also help alleviate the surplus power situation and bring lower rates to consumers. Our nation has been strangled by electric transmission facilities not designed to maximize interchange benefits for consumers, but to keep large utilities in monopoly positions. Our nation needs a nationwide transmission grid. The challenges here are big enough to keep private power company management busy for many years. There is simply no need for encouraging utilities to enter non-utility businesses.

Congress wisely stopped numerous holding company abuses in 1935. At that time the financial posture of the nation was far worse than it is now. History demonstrates that the private companies survived those and later years under the Act. Amendments to the Act are not needed. The Act continues to protect the consumer in its present form and allow diversification under SEC scrutiny. It must be retained.

STATEMENT OF THE
NATIONAL FUEL GAS COMPANY
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ON THE
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
June 15, 1983

National Fuel is one of the three gas companies still registered under the Public Utility Holding Company Act of 1935 (PUHCA). Congressional review of this Act admirably reflects an awareness (though long overdue) that an effective law should not overregulate and should be tailored to meet current public needs. National Fuel continues to believe that today's regulatory and business climate preclude the need for PUHCA. The law is outdated, duplicative and counterproductive with respect to consumer and investor interests. It seriously and unfairly limits the ability of registered companies to compete in the marketplace for capital and acquisitions--a discriminatory effect particularly felt by the three registered gas companies.

As John S. R. Shad, Chairman of the Securities & Exchange Commission, has testified, the abuses of the utility industry which led to the passage of PUHCA were curtailed as long as 20 years ago. In addition, existing laws and regulations would prevent a recurrence of these abuses and they now make PUHCA duplicative in nature. This can be demonstrated by the following: the complex organizational and financial utility structures have been simplified; highly refined uniform accounting standards have been instituted; detailed financial reports to the SEC, FERC, PSC and the public are made regularly; the 1933 Securities Act, the 1934 Securities Exchange Act, as well as state laws insure that the financial and capital structures of all companies are subjected to governmental, business, and public scrutiny; state regulatory commissions have gained plenary regulatory authority over public utility rates, finances, operations and accounting procedures; in addition, FERC has developed equally comprehensive jurisdiction over interstate gas and electric operations.

In fact, the Act's overregulatory effect has become counterproductive. For example, the holding company structure is perhaps the easiest to regulate, but the Act discourages its use. A company could risk the retroactive loss of an exemption or it could be forced to divest any assets invested in a non-utility business. Some of the advantages of the holding company structure are that it separates utility and non-utility corporate subsidiaries, prevents cross-subsidization, facilitates state regulation of utility subsidiaries and of affiliate transactions, allows the company and the Public Utility Commissions to minimize the effect of any loss on the utility and its ratepayers, and facilitates the independent financing of non-utility operations.

In addition, the Act's restrictions on financing are extremely burdensome, costly to implement, and highly discriminatory since no such restrictions are imposed on any other industry or company. This cumbersome and outdated law no longer affects the more than 2,000 gas and electric utilities that originally fell subject to its impact. Today, PUHCA controls just nine electric holding companies and three gas holding companies representing only 20% and 8% of their respective industries' assets. The financing restrictions severely limit management from quickly and effectively pursuing financing opportunities which would benefit the company and its customers through lower costs.

The PUHCA is also counterproductive with respect to its restrictions on diversification. The registered public utility companies must compete as overregulated industries with regulated and nonregulated industries in the capital markets. The risk associated with gas and electric utilities has increased dramatically over the last decade, which makes it difficult for them to attract capital and maintain their financial health since many investors do not see an adequate return relative to the risk of their investment.

The restrictions on diversification should be removed. First of all, investors favor more diversified companies, because the market-to-book ratios usually improve with the degree of diversification of a utility and this helps prevent the dilution of the stockholders' investment. Secondly, the ratepayer would indirectly benefit from a diversified utility because usually such companies receive higher bond ratings. A higher bond rating translates into lower interest costs and ultimately lower utility rates. Finally, the registered holding companies should have the flexibility allowed other companies to preserve and expand their markets, to secure present and future supplies, and to improve their financial stability through diversification. However, state regulatory bodies should ensure that the utility operations and property are treated separately for rate and regulatory matters, so the ratepayer is protected from any business failures and from cross-subsidization.

The opposition to repeal of PUHCA loses sight of the fact that the original purpose of the Act and the main function of the SEC is the protection of investors. PUHCA is no longer necessary and, in fact, is contrary to that purpose. The threat of the Act clearly limits the salability of local utilities which are inefficient and unable to realize the economies of scale which would be available to them if they were part of a larger system. This locks their investors into continued ownership or sale at distressed prices and forces their customers to suffer the costs of these inefficiencies.

In considering the impact of the PUHCA, the unique nature of the natural gas industry should not be overlooked. While the gas industry is reliant on a single, finite resource, the electric industry can use nuclear power, gas, oil, coal, shale and hydroelectric means to service their customers. Electric companies also have the advantage of generating all their own electricity. Gas companies buy the bulk of their product from others, forcing them into the fast-paced arena of oil and gas exploration and frequently into competition with their own suppliers.

In addition, the electric market is not suffering like the gas industry from a decline in demand. Due to the recent dramatic increase in gas prices, the recession, the saturation of most residential and commercial markets and cheaper alternative fuels to which industry is presently turning, gas companies are struggling.

There are other differences between gas and electric companies which deserve mention. Some electric companies do not care to be exempt from PUHCA, while all three registered gas companies do. These gas companies all operate primarily in the Northeast which is projected to be a no-growth area. In addition, there are no giant appliance manufacturers, such as General Electric, researching gas appliances with such mass marketing capabilities. Finally, there are a limited number of uses for gas in the residential market as compared with unlimited electric uses.

Gas companies need, more than most industries today, to have the flexibility to strengthen themselves financially, to fight the symptoms of declining sales, and to compete effectively for finite supplies and capital.

National Fuel offers the following suggestions for improving the status quo:

1. Repeal the Public Utility Holding Company Act. This duplicative layer of regulation is unnecessary and counterproductive, particularly with respect to its financing and diversification restrictions; or
2. Amend the Act by eliminating all references to natural gas, so that the gas industry could join the group of regulated industries (such as water, railroad, telephone, CATV, buses, etc.) which are not restricted by PUHCA; or

3. Amend S. 1174 to allow gas utilities an exemption from the Act by:
   a) adding Sec. 3 (a)(7) to read: "such holding company is a public utility holding company solely by virtue of one or more gas utility holding company subsidiaries,"
   b) or, by adding Sec. 3 (a)(7) to read: "such holding company has one or more public utility subsidiary companies, each of which is a gas utility company whose operations are limited to the state in which the utility company is organized and together, all the gas utility company subsidiaries form an integrated public utility system."

This last recommendation makes reference to an irrational distinction in Sec. 3 of S. 1174. It distinguishes between those holding companies whose utility operations serve more than one state through a single utility company and those holding companies whose utility operations serve more than one state through a series of separate subsidiaries, each of whose activity is limited to a single state. While at first glance it may seem that the holding company system with a single utility subsidiary is a simpler structure, informed reflection will reveal that multiple subsidiaries, each limited to a single state's operations, will simplify the State Regulatory Commission's burden and give the State Regulatory Commission complete control over the activities of the utility company within that state. The single state utility company eliminates all questions of cost allocation, conflicting state policies and conflicts of state interest. Any transactions between affiliates will be governed by contracts subject to state affiliate transactions regulations and all financings by the subsidiaries affecting a particular state will be wholly within the control of that state.

4. Take into consideration those suggestions made by Chairman Shad in his testimony of June 14, 1983, so that we do not find ourselves encumbered with new, additional regulations.

In conclusion, because PUHCA is an example of overregulation, existing laws and regulations would prevent a recurrence of former holding company abuses and because the Act denies the three registered gas companies, our consumers, investors, and ultimately the economy numerous benefits, the repeal and/or recommended modifications to the Public Utility Holding Company act are in the best interest of the American public.

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